Competition in South African Banking

Task Group Report for
The National Treasury & the South African Reserve Bank

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Foreword

In May 2003 the National Treasury requested a study on the competitiveness of South African banking, along the lines of similar studies done abroad (e.g. The Cruickshank Report in the UK and the Wallis Report in Australia). The idea was to build on these studies and see to what extent competition in the banking sector in South Africa differs from industrial countries. The South African Reserve Bank wholeheartedly supported the National Treasury's proposal and various staff members of the Bank were made available on a part-time basis to support the project. While the Cruickshank and Wallis Reports were the work of fully-fledged commissions of inquiry with full-time professional staff working with the assistance of experts supplying countless man-years of input, this study was to be done on a part-time basis within a year[1]. What was called for was an overview of the territory and the identification of any blatant competitive shortcoming in the banking sector. Accordingly the study had to involve only desk research, surveys of the literature, and interviews with bankers, bank customers and competition authorities. This was to be undertaken in the light of agreed terms of reference and within the agreed period.

[1] The UK enquiries are instructive in that they highlight key issues to consider when analysing competition in SA banking. Many of these issues are also relevant in South Africa. In this sense, the UK acts as a benchmark for this Report.

Introduction

1. The scope of the investigation

The banking sector is usually the largest single component of the financial system, which also includes securities firms and insurers. Within the financial system banks need special treatment because:

- Banks are unique financial institutions, particularly so because of their unique balance sheet structures: i.e. money-certain liabilities and money-uncertain assets.
- Their functions impinge on all aspects of the economy and are central to the overall performance of the economy. The efficacy of the financial system in performing these functions is a major ingredient of the efficacy of the economy as a whole.
- Banks dominate the national payments system. In practice the safety net arrangement of the central bank is available only if the failure of a financial institution endangers the national payments system. Such failure nearly always involves a bank[2].
- The development of financial conglomerates complicates the supervision of banks, but not sufficiently so to warrant the view that banks have transformed themselves into a new type of financial institution. While attention to the regulation of complex groups[3] is imperative, the deposit-taking activities of banks still stand in sharp contrast to the financial services rendered by non-bank financial institutions. Deposit-taking banking activities are something quite different from other financial activities.

The following banking activities are excluded from this investigation:

- *Central banking:* Although monetary policy and the regulatory environment have a distinct impact on the overall financial structure of any country (and thus have a competitive dimension as well), aspects of central banking will be addressed only in the broader context of the financial system.
- *Corporate and merchant banking:* The checks and balances in the corporate sector are very different from those of the retail markets. Usually corporates have sufficient financial power to ensure competitive pricing in the wholesale financial markets. Moreover, in South Africa the corporates themselves are major shareholders of banks, which in turn ensure that their commercial interests are catered for at the highest level. Generally speaking, the wholesale markets in South Africa are buyers' markets, in contrast to the retail markets which are largely sellers' markets.
- *Bancassurance:* Insurance and securities trading activities handled by the banking system fall outside the ambit of this research project.

This study focuses thus on competition in banking in general and retail banking in particular. A grey area between the retail and wholesale financial markets is the

[2] Strictly speaking the lender-of-last-resort facility was never intended to be limited to banks only, as the central bank has to supply liquidity – usually through the banking sector – to any institution that may create problems in the financial system.
[3] Complex groups are large financial conglomerates that operate in various markets and jurisdictions. Once a financial conglomerate begins to look at its risk on a global, group-wide basis, the balance sheet of one part of the group becomes progressively less important.

market for small and medium enterprises (or SMEs). Small businesses, and micro enterprises particularly, are similar to retail business, while larger medium-sized businesses are closer to the corporate market. Accordingly only the smaller SMEs will be discussed in this study.

2. The South African banking industry

South Africa's central bank is the South African Reserve Bank (SARB). The Bank Supervision Department of the SARB has prudential and regulatory authority over the banking industry. As of December 2003, there were 22[4] operating commercial banks (of which 17 are locally controlled) and 15 local branches of foreign banks. There are two mutual banks[5] but no building societies. In addition, there are some 47 representative offices of foreign banks.

The five largest commercial banks (accounting for some 86% of deposits[6]) are ABSA, First National, Investec, Nedbank and Standard Bank, with Investec being the smallest of the five.

By law, only registered banks may take deposits, however, Postbank is exempt, as are the informal[7] village financial services co-operatives (or village bank) and credit unions. The exempt institutions are regulated by self-appointed industry regulators. SACCOL is the regulator of credit unions or savings and credit co-operatives (SACCO's)[8]. SACCOL has some 31 registered SACCO's representing a membership of 8884 individuals. Together, the deposit base of village banks and SACCO's is, at its largest, an estimated R37 million. This accounts for less than 0.005% of the deposit base in the banking industry[9].

Category	**Members (with PASA Membership)**
Big 4	ABSA, FirstRand, Nedcor, Standard Bank.
Big 5	ABSA, FirstRand, Investec, Nedcor, Standard Bank.
Locally controlled banks	Big 4 (whose throughput ratio accounts for 99.7%* of the payment system), together with: African Bank, Mercantile Bank, Capitec Bank Limited, Gensec Bank, Imperial Bank, Investec Bank limited, Marriott Merchant Bank Limited,, MEEG Bank, MLS Bank, Peoples Bank Limited, Rennies Bank Limited, Sasfin Bank Limited, Teba Bank Limited.
Branches of foreign banks	ABN Amro Bank, Bank of Baroda, Bank of China, Bank of Taiwan, Barclays Bank, China Construction Bank, Citibank NA, Commerzbank Aktiengesellschaft, Credit Agricole Indosuez, Deutsche Bank AG, HSBC.
	Bank plc, JP Morgan Chase Bank, Society General, Standard Chartered Bank, State Bank of India.
Banks with membership	ABSA, FirstRand, Nedcor, Standard Bank.
of all PCH's (Payments Clearing Houses)	(ABSA and Standard Bank have added functionality with Nupay)
Foreign controlled banks	Albaraka Bank Limited, Habib Overseas Bank, HBZ Bank Limited, Mercantile Bank Limited, South African Bank of Athens.

* As at end of 2003

Source: KPMG and National Payment System Department of the SARB

[4] Excluding banks in liquidation or curatorship
[5] Mutual banks have lower capital requirements.
[6] As at June 2003
[7] A term used by the SARB, see Factsheet no. 10 www.reservebank.co.za
[8] The regulators of the Village Financial Services Co-operatives are currently not functioning. It is estimated that some 50 co-operatives are still operating, however.
[9] Expressed as a percentage of average total industry deposits, which in 2003 amounted to some R795 billion (SARB, Quarterly Bulletin, December 2003).

3. The method of the investigation

The research project is tackled along the following lines:

Chapter 1 sets out the current thinking on competition and profitability as it relates to banking and examines which ideas are applicable to South Africa.

Chapter 2 gives an overview of international banking systems and considers to what extent South Africa is in line with international standards in terms of profitability and efficiency.

Chapter 3 provides an analysis of economic concentration in the banking sector. It also examines evidence for outcomes which may indicate concentration in the sector, in terms of X-inefficiency and pricing structures, within market segments.

Chapter 4 simulates revenues and costs of commercial banks for custodian, transmission and lending processes, among others.

Chapter 5 simulates the revenue and costs drivers of possible new entrants to the sector, in the light of proposed amendments to the Banks' Act to allow for second and third-tier banks[10].

Chapter 6 examines the payment system, its mechanisms and ownership, as this is an essential infrastructure to the banking industry.

Chapter 7 evaluates the position of the underbanked in South Africa and sets out the elements of a possible "basic banking product" to be developed for the underbanked. The role of the authorities in the process of delivery of such a product is also considered.

Chapters 8 and 9 examine the retail banking services for individuals, and small and medium enterprises. It is in this analysis of the different market segments that much can be learnt regarding competitiveness of the industry. In the Cruickshank

[10] In contrast to first-tier banks (which typically operate on the full spectrum of e.g. credit-risk, liquidity-risk, interest-rate risk, and currency risk management), *second-tier* banks are prohibited to use public deposit for (illiquid) lending to the private sector. *Second-tier* banks may be "narrow" or "core" banks: In case of a so-called "narrow" bank all deposits liabilities are invested in approved highly-liquid money-market instruments and no other credit business is allowed, while so-called "core" banks can engage in lending to the private sector provided such loans are funded from their second-tier capital (in essence the core banks' subordinated debt). For more detail see: Bossone, B., "Should Banks be Narrowed?", IMF Working Paper, WP/01/159, Washington, 2001.

Third-tier banks, like first-tier banks, can use deposit liabilities for lending to the private sector, but only if their depositors and lenders are from the same community. In essence *third-tier* banks are relatively smallish operations such as village banks, stokvels (rotating saving schemes), community banks, small local mutual building societies, and co-operative banks. The key issue here is that the possible bankruptcy of a *third-tier* bank should have no systemic risk whatsoever for the financial sector at large.

An important difference between first-tier and lower-tiered banks is the philosophy of the legislation supporting their daily operations. Stated somewhat in the extreme: in the case of first-tier banks everything is allowed unless prohibited in law, while for lower-tiered banks everything is prohibited unless specifically permitted in terms of legislation.

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report, for example, it was in the individual and small business market segments that banks were seen to have excessive market power and inadequate disclosure. In chapter 9, an exploration as to what extent banks may hamper the development of small and medium businesses is provided, as well as an examination of both the volumes and costs of credit to this market segment.

Chapter 10 provides an analysis of disclosure of charges and implicit conditions to customers, other competitors, the regulator and both shareholders and stakeholders.

Chapter 11 examines the extent to which the broader policy environments of the banking sector in South Africa and abroad are aligned so as to enable competition.

Chapter 12 contains the conclusions and recommendations for the way forward.

Since this investigation is no more than a pilot study, a lot of the required data was not readily at hand. The banks may have such data but for competitive reasons are unwilling to share this sensitive information with outside bodies. Moreover, the current returns to the Registrar of Banks focus virtually exclusively on prudential issues. It would require a totally new return of the Registrar of Banks to gather appropriate information of competition issues. And to build up such a data bank may take many years, even after agreement has been reached between the banking industry and its regulators. In this study estimates by the Chief Financial Officers were used as substitutes for missing data, i.e. estimates of the professionals were used as conceptual bridges.

4. The relevance of the UK studies on competition in banking for SA

The three reports in the UK[11] have identified several key issues related to competition and profitability in the British financial system (for more detail see Appendix 1.2). A fourth report in the UK (i.e. the Sandler Report) also considered weaknesses in the market for retail investment products and services. Between them, these reports highlight issues that are relevant also for South Africa. Several specific issues are highlighted for attention in such a study and all are drawn from the experience of the exhaustive enquiries in the UK:

- The profitability of South African banking compared with other countries.
- The importance of competition in banking.
- Measures of competition, contestability and effective competition.
- Measures of concentration.
- Nature and extent of entry barriers.
- The identification of relevant banking sub-markets.
- Differences in competitive conditions between sub-markets.
- Consumer behaviour patters, e.g. with respect to switching.
- Issues of transparency.
- Pricing strategies and price competition.
- Complexity of charges.
- The efficacy of competition in practice.
- Degrees of switching.
- Directional impacts of differences between sub-markets.

[11] The Cruickshank report, the Competition Report into Banks and SMEs and the Competition Inquiry into the proposed purchase by Lloyds TSB of Abbey National

- Elements of complex monopoly.
- Nature and extent of impediments to competition.
- The extent of supply and demand bundling of financial products and services.
- How banks compete in practice.
- Issue of complex monopoly.
- Costs and benefits of competition.

5. Financial aid received

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Chapter 1

Competition and profitability: a broad overview

This chapter consists of the following sections:

1. The issues.
2. The importance of competition in banking.
3. Competition, contestability and effective competition.
4. How banks compete.
5. Markets versus institutions.
6. Entry barriers and contestability.
7. A contestability matrix.
8. The new entrants.
9. Profitability and excess returns.
10. Competition policy.

and the following appendices:

1. The functions of the financial system and the role of banks.
2. The enquiries into competition in the UK.
3. EU competition policy in the banking sector.

The purpose of this chapter is to show why competition is important in banking and the financial system, given the pivotal role that banks play in the economy and the importance of the financial system. A distinction will be made between competition, contestability and effective competition. It will be emphasised that the banking sector should not be seen as a single business, but rather as a set of sub-markets between which competitive conditions can vary substantially. The ways in which competition can be impeded in the banking sector will be illustrated.

1.1 The issues

Competition is as at least as important in banking as in any other industry. Competition has implications for efficiency, innovation, pricing, availability of choice, consumer welfare, and the allocation of resources in the economy. The functions of the banking system[1] including providing a payments and settlements system, mechanisms for borrowing and lending, and pooling and allocation of funds, among others, impinge on all aspects of the economy and are central to the overall performance of the economy. The efficacy of the financial system in performing these functions is a major ingredient of the efficacy of the economy as a whole. Given the pivotal role of banking in an economy, the role of competition in this industry is particularly important.

Competition issues have also arisen in many countries in the light of proposed bank mergers.

There are several issues to consider in the analysis of competition in banking:

- The importance of competition in banking.
- Competitiveness in the market place.
- The impediments to competition in the banking sector.
- The extent to which banking is to be regarded as a homogeneous industry or alternatively as a set of sub-markets between which competitive pressures may vary considerably.
- The nature and extent of entry barriers in some banking markets.
- The extent of monopoly power.
- The ways in which banks compete with non-bank suppliers.
- The role of price competition.
- The extent to which some banking markets have become more *contestable.* Competition is not necessarily measured by the number of firms competing in a market.
- The extent to which competition is *effective* in the market place. Are consumers in a position to make rational choices and are they in a position to exercise choice effectively (i.e., are there low switching costs?). Competition may appear to be strong and yet not be effective.
- The existence of excess returns.
- The extent to which excess returns result from the exploitation of market power.
- The link between the regulatory environment and competition and efficiency.

Considerations such as these have produced three major Committees of Enquiry in the UK. Due to a suspicion that small and medium-sized enterprises (SMEs) were not being served well by their banks, the Treasury instituted an enquiry in 1999 by Don Cruickshank into banking for SMEs. This was followed by a lengthy and detailed enquiry by the Competition Commission (UK CC), which produced an eight volume report under the title *The Supply of Banking Services by Clearing Banks to Small and Medium-sized Enterprises* in 2002. There was a second UK CC report following the proposed purchase of Abbey National by Lloyds TSB in 2002.

A key issue is the extent to which the questions and issues raised in these reports are of relevance to South Africa.

1.2 The importance of competition in banking

Competition is important in all industries as it is a spur to efficiency, innovation, consumer choice, quality of goods and services, and low prices. If competition is weak these advantages may be lost and there is likely to be a transfer of welfare from consumers to both the producers of goods and services and the shareholders in these firms.

Because of the central role of the banking system in the economy, the role of competition (and the costs of its impairment) are particularly important in banking. The functions performed by the financial system (see Appendix 1.1) are crucial to the efficiency of the economy. This impact derives from considerations such as the cost of financial intermediation, the incentives to save and invest, the allocation of resources, the shifting and sharing of risk, the discipline imposed on borrowers by the lenders of funds, etc. Equally, differential access to the services of the financial (banking) system has important distributional effects in the economy. The financial system is also a significant absorber of real resources. Thus, the efficiency of the financial system in the performance of its basic functions has both growth and distributional dimensions in the economy.

If the banking system applies inefficient risk analysis criteria that do not maximise risk-adjusted rates of return (perhaps because they exclude some potentially valuable high-risk projects) the overall performance and efficiency of the economy may be impaired. Moreover, if banks do not price risk efficiently (e.g. by under-pricing some loan risks while over-pricing others) an inefficient allocation of resources will emerge to the detriment of the overall performance of the economy. If the banks are inefficient, or are able to earn excess returns through charging a wide margin between deposit and lending rates, some viable projects may remain unfinanced or financed only at excessive cost.

All these considerations are relevant to an analysis of competition because competition is a major spur to efficiency.

While competition may result in weaker firms withdrawing or becoming insolvent as part of natural processes, this is not necessarily a desirable outcome in banking. Rubin (1997) notes that: *'although for ordinary businesses insolvency is viewed as a quasi-Darwinian mechanism that improves the health of the corporate herd, for banks it is viewed as a social disaster'*. This is both because the social costs of bank failure may exceed the private costs and because it can involve the destruction of valuable information about corporate customers. Some see the banking industry as one where competition is best fostered by free entry and exit. It may be that there is a trade-off between stability and competition.

[1] See Appendix 1.1 for a further discussion on the functions of the banking system and the role of banks

1.3 Competition, contestability and effective competition

Three alternative concepts are relevant in any analysis of competition in the banking industry: *competition, contestability* and *effective competition.* The first-mentioned focuses on the traditional way of considering competition in an industry and considers factors such as the number of suppliers, the market share of the dominant players (as, for instance, measured by Herfindahl indices), etc. This dimension also considers the type of competition in an industry: perfectly competitive, *complex monopoly*, monopoly, oligopoly, etc.

In some industries (and in some banking markets) the traditional way of measuring competitive conditions has become less appropriate. A market is said to be *contestable* if entry and exit barriers are low: i.e. it is easy for new firms to enter the industry and at low cost, but equally easy (and at low cost) to exit. In this case, incumbent firms are restrained in exercising monopoly power (such as through high costs, prices, and profits) because if they were to exploit market power this would immediately induce new firms to enter the market. In the extreme case of perfect contestability, even a monopolist would be forced to behave as if it faced many competitors because of the threat of entry by others if it did not behave in this way. It is the credible *threat* of entry that deters anti-competitive behaviour by incumbents. While the number of actual competitors is largely irrelevant in determining competitive conditions in a contested market, the numbers of players becomes of greater concern where there are high barriers to entry or restricted access to essential infrastructure.

A market can be competitive (as measured in the normal way) but competition may nevertheless not be *effective* in the market place. Even though there may be many competitors in a market, competition is only effective in practice if the consumer is (i) able to make a rational choice between competitors, and (ii) is able to exercise choice at low transactions costs. Both may be impeded. The two concepts are briefly considered:

(i) Consumers unable to make rational choices

Some of the reasons the consumer may be unable to make a rational choice are:

- Lack of relevant information.
- The complexity of products.
- Complexity of charges.
- Headline pricing to conceal other characteristics.
- Obfuscatory pricing.
- The inability to observe quality at the point of purchase.

If consumers do not have sufficient information by which to make comparisons and rational choices, competition between suppliers may not be effective in practice. For instance, one needs to be mathematically well schooled to calculate (and thus check) the annual rate of interest on a credit card. Moreover, current account holders are not always aware that they could pay lower interest rates if they switched banks.

(ii) Constraints on exercising choice

Even if the consumer is able to make a rational choice, the transactions costs of exercising this choice may be high:

- The *bundling* of products and services may be such that the purchase of one service may be dependent on the purchase of other services. For instance, loans to SMEs are often dependent on the individual firm having many other services supplied by the same bank. Thus, while Bank A may provide service X better than any other bank, this may not be so for all other services that go with X.
- There may be considerable inconvenience attached to buying a particular product from a particular bank if, because of unbundling, many other services need to be switched.
- Switching costs may be high.
- Consumer inertia may inhibit switching and the search for the best deal.
- Redemption penalties may be high in some financial products (especially those of a long-term nature).
- There may also be costs in disturbing an existing relationship with a bank because of the information transfer gained though a long-term association. This can work to the advantage of both the bank and the customer. It means that there may be considerable inertia in switching accounts.

Lack of information is the major constraint for consumers to make rational choices (i.e. concept (i) mentioned above), while transaction costs constrain the exercise of choice (i.e. concept (ii) noted above). Combined, they can have the effect of limiting the effectiveness of competition even in a market place which is contestable or one which already has many competitors.

The effectiveness of competition can also be determined by the type of good or service being purchased. A distinction is usually made between: *search*, *experience* and *credence* goods and services. The distinction is relevant for both information and transactions costs issues. In the case of *search* goods, quality and price can be ascertained at low cost prior to purchase or where a credible warranty is attached. *Experience* goods are those whose quality can be ascertained at low cost through use though not prior to purchase. While the element of uncertainty at the point of purchase is clearly higher than in the case of *search* goods, the degree of uncertainty is bounded. *Credence* goods, on the other hand, are goods where quality can be ascertained only at some cost after purchase and, in its extreme form (such as some long-term investment products), may never be fully open to objective evaluation. A frequent characteristic of these goods and services is that the value of the purchase is either spread over a long period of time, or emerges only after a considerable lapse of time.

One of the other characteristics of many financial transactions is that they involve *incomplete contracts*, in that their value is determined in large part by the behaviour of the seller/supplier after the point of purchase. Two obvious examples are where an investment manager turns out to be incompetent or even corrupt, or where a financial institution becomes

insolvent while having fiduciary commitments to its customers.

These considerations can impair the effectiveness of competition even if there are many competitors.

1.4 How banks compete

Banks compete in various ways both between themselves and with other financial institutions and markets. In those markets that are *contestable*, they also compete with potential new entrants. In general, banks compete in terms of: price, service standards, delivery channels, advertising, innovation in products and services, the range of products and services offered, relationship management, and product differentiation.

In general, **price competition plays a limited role and many of the routes through which banks compete have the effect of raising costs.**

The absence of price competition was highlighted by the UK Competition Commission (UK CC) enquiry into banking services for SMEs. This absence (indeed, the practice of oligopolistic pricing in this sector) was highlighted as a symptom of a lack of strong competition in the markets for some banking services for SMEs.

The UK CC was particularly interested in the relationship between price and profitability in the market for SME banking. Their general approach is summarised in the following quotation taken from Volume 1 of its Report:

"To the extent that companies in a market restrict price competition, there will be a tendency for customers to be overcharged for the products and services they acquire. Therefore establishing the extent to which, if at all, customers are being overcharged is an important further means of determining whether competition is adequate or restricted. ……. We examine whether prices generally are above the level that would exist in a fully competitive market. This will generally be the case where the profits from the prices charged are, over a period, significantly in excess of the cost of capital…"

The UK CC also considered the problem that similar prices charged by competing firms may be indicative either of intense competition (when competition forces the prices of all firms down to their minimum sustainable level), or of the absence of competition with or without collusion or oligopolistic pricing. The UK CC commented as follows on this issue:

"One way of distinguishing whether price parallelism reflects intense competition or failure to compete is the level at which price parallelism occurs. If it occurs at a level of prices broadly equal to the cost of capital, it is, in our view, more likely to be indicative of competition acting as a stimulus to reduce prices to such a level. If it is at a price level that gives excess profits, then it would indicate a lack of competition. In a concentrated market that would, in our view, arise from a mutual if independent recognition of the desirability of not significantly undercutting each other on price."

When judging the competitive condition of the banking industry, the competition authorities usually focus on the extent of excess returns earned by banks. Excess returns may be defined as a rate of return on equity in excess of the cost of capital where the cost of capital (as, for instance, measured by the CAPM[2]) is the return necessary over the longer term to remunerate investors and hence ensure an adequate supply of capital funds when required.

1.5 Markets versus institutions

A key issue in competition in the banking industry is whether the focus should be on the total market or on individual banking markets. In the latter case the issue arises as to how to define the relevant markets. The general conclusion is surely that banking is not a homogeneous business and therefore the focus should be on sub-markets.

Banks are involved with different customers, different markets, and different products in each market. Sub-markets must be taken into account because:

1. Competitive conditions vary between sub-markets.
2. Consumer behaviour is different in each market.
3. The profitability of different markets varies (though this raises the complex issue of how to apportion the costs of the bank to different parts of the business).
4. There are cross-subsidies between markets (where prices in some markets are set high relative to cost and risk while in others they are set low).
5. Banks compete differently in different sub-markets.

Any investigation of competition in the South African banking industry must, therefore, focus on sub-markets. Banking is not a homogeneous business.

The question is how to define the relevant sub-markets in which competition must be analysed. This, to some extent, is determined by the degree of substitutability by the consumer. Thus if products A and B are easily substitutable, then it is appropriate to consider A and B as part of a single market. Thus, many consumers might consider a term loan

[2] The CAPM or Capital Asset Pricing Model measures the cost of capital as the return on risk-free securities, plus the company's systematic risk, multiplied by the market price risk (market risk premium) (Copeland, et al, 1996).

Hence the cost of capital of banks can be calculated as:

$$R_e = R_f + ß \times MR_p$$

where

R_e = Rate of return demanded by investors in equity investments (in short referred to as the cost of equity capital).

R_f = Rate of return available in the market on risk free (i.e. without default risk) interest-bearing investments (in short referred to as the risk free rate).

ß = The specific (as opposed to market) risk of the particular equity investment, relative to the market (in short referred to as the beta). Generally, the beta for large commercial banks is assumed to be 1 as they are typically highly diversified and exposed to the whole economy with limited bias to specific sectors of the economy.

MR_p = This is the difference between the expected rate of return on the market portfolio and the risk free rate. In other words, it is the premium above the risk free rate demanded by the investors as 'compensation' for undertaking the higher risk endeavour of investing in equity investments.

and an overdraft to be highly substitutable in which case both are part of the lending market. On the other hand, a current account and a leasing contract are clearly not substitutes and hence they are both to be regarded as sub-markets. The distinction is not always obvious. Are, for instance, current accounts and savings accounts to be regarded as substitutes in that a consumer can always save in a current account? Are current accounts for persons and businesses to be regarded as part of the same market? In practice, the answer is likely to be no in both cases.

1.6 Entry barriers and contestability

The nature of contestability was outlined in an earlier section. While competition (measured by the number of competitors) may be low competitive conditions may be strong in a particular market if it is contestable. The key characteristic of contestability is that entry and exit barriers should be low. In practice, there are many entry barriers into banking:

- **Sunk costs** may be high: i.e. those costs that are incurred on entry but are not recouped when the firm exits the market. One such sunk cost is the cost of establishing a delivery infrastructure. The up-front set-up costs may be high.
- **Brand and reputation** may be an entry barrier in some markets. Thus if incumbents have a strong brand value, and if reputation is an important consideration for the consumer, new firms may find it difficult to enter and compete effectively.
- **Consumer perceptions** may act as an entry barrier in that a new entrant might not be viewed as a credible supply of banking services and products.
- Barriers to key or essential **infrastructure** such as the payments system can place new players at a disadvantage and constrain their growth.
- In many markets there are substantial **information problems**. A new entrant into the lending market for SMEs may face substantial problems in accessing information about the credit standing and risk characteristics of SME borrowers.
- Consumers may incur high **search costs** for alternative products.
- In order to overcome high consumer search costs, the need for a large initial **advertising** budget to make consumers aware of a new entrant may act as an entry barrier and these are inevitably sunk costs.
- If the demand for a good or service is **price inelastic**, the new entrant (while it may have lower costs than incumbents) may find it difficult to shift customers away from their traditional suppliers. If this is anticipated, new entrants may not enter the market.
- There may be **consumer-switching costs** in which case a new entrant may not gain business even though its costs and prices are lower than those of incumbents.
- If **consumer inertia** and a reluctance to switch exist, new entrants will be deterred.
- **Scale barriers may exist**. If there are economies of scale in an industry the incumbent has inherent advantages because it has an appropriate scale. A new entrant, on the other hand, cannot achieve optimum scale immediately at the point of entry. It may take some considerable time (and risk) before optimum scale can be attained and this depends upon its ability to tempt customers away from incumbents.
- A new entrant faces a risk that, upon entry, an incumbent immediately lowers price to a long-run unsustainable level in order to force the new entrant out of the market. The risk of such potential for **predatory pricing** acts as an entry barrier especially if new entrants judge that incumbents could sustain lower prices for a lengthy period.
- A further entry barrier is the possibility that, on entry, incumbents will **negotiate** with their customers (who potentially might switch) special deals that would not have been made in the absence of a new entrant. The entry barrier is not the deal itself but the threat of such deals.
- The business may require high **skills and experience** in order to be successful.
- The **complexity of the product** may act as an entry barrier in that it is difficult for a new entrant to compete by demonstrating the superiority of its product or service.
- If banking products and services are **bundled** (in that the purchase or supply of one product is dependent on the purchase of another) a new firm can enter only if it is able to offer all the bundled products. However, it might have a competitive advantage in only a very narrow range of the bundled products and services. For instance loans to SMEs are often only feasible if the lender also holds the current account of the borrower. Two types of bundling may occur: **demand bundling** (where the consumer chooses to bundle different products and services for convenience and possibly cost) and **supply bundling** where the supplier will supply one product only if another is also bought by the consumer. In other words, bundling may be either voluntary or imposed. In either case the new entrant may not be able to enter a market even though it has a competitive advantage in a particular product.
- The absence of a **delivery infrastructure** such as a branch network may serve as a barrier to entry. This barrier is lessened to the extent that financial products and services can be delivered remotely (through the Internet) or though access to existing delivery channels owned by other firms.
- If the product requires an **integrated set of processes** new entrants may be deterred. They may have an advantage in terms of the basic product, but may not have the skills or capacity in processing.
- **Low transparency** in products may act as an entry barrier because new entrants are unable to demonstrate superiority.
- **Regulation** may impose entry barriers through, for instance, the requirement to have a minimum amount of capital at the outset and the requirement to demonstrate fit and proper criteria of solvency, integrity and competence.

Many of these entry barriers may be quite powerful in at least some banking markets and may mean that excess returns can be sustained for some incumbents. The entry barriers may also foster the existence of some anti-competitive practices.

In the UK the UK CC considered in detail how entry barriers might operate in the SME banking market. In the process they identified the following barriers to entry:

- Information problems for new entrants about the credit standing of SMEs.
- The free banking provided by incumbents to some 20 per cent of their customers created pressure on new entrants to offer it to the majority of their customers.
- Incumbents had scope to negotiate with customers who were considering switching.
- The existing personal customer base of the incumbents from which a large proportion of SMEs emerge.
- The low degree of switching in the SME sector.
- New entrants' lack of an extensive branch network.
- The importance of reputation in the eyes of the customer.
- Access to relevant skills such as credit assessment and relationship management.
- Economies of scope in the provision of a range of services: in particular, the "first port of call" advantage.

The entry problems may be divided into four main areas, namely (1) deterrence to entry, (2) cost and pricing asymmetries facing new entrants, (3) the advantages of incumbents, and (4) the difficulty in gaining customers.

However, the UK CC also stated that: *"We do not see such barriers applying to other lending or deposits, as evidenced by the extent of entry and the greater number of suppliers in these markets."*

In the UK and other European countries the degree of contestability in some banking and financial markets has increased. Many of the entry barriers noted above have been lowered partly because of the impact of technology (Llewellyn, 2002). The process of *deconstruction* whereby component parts of banking products are supplied on an outsourcing basis has the effect of lowering scale barriers, delivery barriers, set-up costs, skill requirements, and the barrier of integrated processes mentioned above. To the extent that consumers have become more prepared and able to unbundle, this potential entry barrier has also weakened. In particular, the process of deconstruction and outsourcing means that a new entrant is no longer required to supply all the components within the value chain but is more able than in the past to concentrate on that part of the product in which it has a potential competitive advantage. The development of the Internet has also lowered entry barriers in that it has lowered consumer search costs.

The development and increasing sophistication of credit-scoring models has made it easier for new entrants to enter some lending markets. The development of technology may also have lowered some traditional information barriers to entry to the extent that it has increased the supply and lowered the cost of some information needed to provide certain financial products and services.

The development of the Internet has had the effect of lowering entry barriers into at least some sub-markets in the banking industry. In particular, it has lowered the marginal cost of transactions, has made distance and location increasingly less important, has lowered consumer search costs, has increased the availability of information and lowered the cost of price discovery, and has raised transparency.

1.7 A contestability matrix

The degree of contestability varies considerably between sub-markets. While new entrants have entered some sub-markets in the UK others have been untouched. The UK CC noted there are few suppliers and high entry barriers in the markets for liquidity management services and general-purpose business loans. The UK CC noted that there has been only limited entry by suppliers into the provision of liquidity management services, in particular current accounts with overdrafts and bank loans. Indeed, some new entrants have withdrawn. On the other hand, there are many suppliers of other banking services to SMEs. Many of the suppliers of other deposit accounts and asset-related loans have entered the market within the last ten years. As noted by the UK CC: *"this shows the relative ease of entry into these activities on a niche basis"*. There has also been some entry into the supply of current accounts without overdrafts. In some personal banking markets (notably savings accounts), on the other hand, there have been several new entrants including Supermarket Banks.

Thus the degree of contestability varies considerably between sub-markets in banking. This can be represented in a Contestability Matrix (Table 1) where sub-markets are defined in terms of both customer groups and products. The numbers indicated in each cell (i.e. each sub-market), indicate the relative ease of entry into different sub-markets, and hence their contestability. For example while the sub-market for loans is highly contestable for large firms, it is less so for high and low-income individuals. It is not contestable for small firms. The numbers shown here are illustrative only. Nevertheless, the matrix is likely to be a reasonably accurate reflection of the relative contestability of each sub-market.

Table 1.1: Contestability Matrix

	Customer groups			
	Individuals		**Firms**	
Products/ services	High income	Low income	Large	Small
Payments	4	2	5	2
Loans	8	6	10	2
Deposits	6	4	10	5
Advice	7	5	10	3

Score: 10 is high contestability. 1 is low contestability

1.8 The new entrants

In many industries competition is especially powerful when it develops from outside the traditional industry. There are several reasons for this: new entrants have cost structures and levels of costs different from that of incumbents. They are more prepared to challenge

traditional ways of conducting business, the basic economics of the firm is different, different business models are applied and they apply a different business strategy and business mix of products and services. The incumbents often do not understand the business models of the new entrants and find it difficult to develop competitive strategies against them.

In some countries new entrants into some banking sub-markets have included supermarkets, motor car manufacturers, DIY furniture stores, the Post Office, utility companies, insurance companies, and even well-known football clubs! The new entrants tend to have certain common characteristics:

- Entry barriers for the new entrants are low in the relevant sub-markets.
- They utilise innovative technology and new forms of delivery.
- They often have a core competence in retailing.
- They tend to have an image of reliability, quality and customer service in their existing business.
- They are highly focussed in the product range and offer only a limited range of products and certainly not the full range of products and services offered by conventional banks.
- They frequently exploit existing cross-subsidies by incumbents and focus on those parts of the incumbents' business that is being used as a subsidiser.
- They are focussed within the value chain because they outsource a large proportion of processing.
- They have low fixed costs (partly because they do not have the substantial costs of establishing a processing infrastructure) and have low costs generally.
- They have no legacy costs through dated systems and infrastructure.
- They often enter the market in partnership with an incumbent bank.

The impact of new entrants is not measured by the market share they secure which may be quite limited. The biggest impact is in terms of how they force incumbents to behave differently.

1.9 Profitability and excess returns

When one looks at competition in banking, a central issue is the extent of any excess returns being earned by banks over a period of time. Excess returns are defined as the return on equity in excess of the cost of capital.

The UK CC report on banking services to SMEs states:

"We recognise that profitability is absolutely essential to the effective and efficient working of a market economy, both as an incentive to companies and as a return to the suppliers of equity capital. Profits are indeed the engine in the dynamic process of competition, innovation and meeting customer needs. This, however, in our view does not automatically justify any level of profits and prices that may emerge in any given situation. In some circumstances profits can be derived from the exercise of market power or a more general lack of competition, manifested through overcharging of customers and, as a result, reducing the effectiveness of the competitive process".

Not all positions of excess returns are necessarily against the public interest. For instance, in the case of banking, if the social costs of a bank failure exceed the private costs (because of the potential systemic cost of an individual bank failure) excess returns may be viewed as a cost worth accepting for a more stable banking system.

The issue of excess returns is a complex one. Firstly, excess returns in an individual firm do not automatically mean that there is a lack of competition. However, if most or all suppliers have a return on capital greater than the cost of capital, this is likely to be indicative of excess profits and prices and a lack of effective competition. Secondly, the method for measuring a bank's cost of capital is itself complex[3]. Thirdly, it is very difficult in practice to measure costs and returns in sub-markets. Fourthly, there is controversy over what time period the cost of capital and rates of return should be measured. The last-mentioned is particularly relevant given that bank profits are known to vary over the business cycle in the economy[4].

Many serious problems surround the measuring of the cost of capital and the extent to which any excess returns are a reflection of a lack of competition (see Appendix 1.2). Nonetheless, if most or all suppliers have a return on capital greater than the cost of capital on a basis adjusted to represent long-term profitability, there is likely to be excess profits and an absence of fully effective competition.

1.10 Competition policy

Competition policy can be seen as a form of regulation intended to bring out the best of *laissez faire*. If competition policy succeeds, other forms of economic regulation will become less necessary. Judicious use of one kind of economic regulation – competition policy – can lower the aggregate regulatory burden. Effective competition policy is, in economic terms, the consumers' best friend.

Seen from this regulatory perspective it is informative to evaluate the competition laws of the European Union, which are applicable to all member states irrespectively of their degree of economic development[5]. A summary of the EU competition legislation is given in Appendix 1.3 below as well as the possible consequences of such legislation should it be applied to South Africa.

[3] As is further noted in Chapter 2, it was not possible to calculate the cost of capital in this report due to a absence of data from the banks.

[4] Bank profits tend to be cyclical in several ways. The demand for credit, the proportion of total borrowing of a distress kind, provisions and bad debt experience and the value of collateral all tend to move with the cycle (although not necessarily in the same direction). For this reason, any calculations should not be related to any particular phase of the cycle. Ideally, any calculation would cover at least one full economic cycle.

[5] EU law is a compromise between all member states and has a tendency to strive for a minimum standard. It for this reason that EU law is more recommendable for South Africa (i.e. as an objective quality standard) than the legislation of individual states that are always coloured by their specific history and culture.

Appendix 1.1

The functions of the financial system and the role of banks

The financial system comprises a set of financial markets, institutions and exchanges, which, to some extent, are in competition with each other.

The financial system performs **financial intermediation** services and provides a wide range of other **financial services** including insurance and fund management.

It creates a wide range of **assets and liabilities** for consumers, and engages in **asset transformation,** as the diversity of assets and liabilities enables risks to be shifted to those who are more willing and able to accept them.

These broad functions of the financial system may be more specifically defined in terms of a set of universal functions:

- It provides a **payments and settlements system**.
- It provides mechanisms for the **borrowing and lending** of funds so as to remove short-term budget constraints.
- It provides mechanisms for the **pooling of funds** and the financing of large-scale projects.
- It bridges different **portfolio preferences** of ultimate suppliers and borrowers of funds.
- It provides mechanisms for the **transfer of financial (and hence real) resources** over time, space, and agents.
- It enables **allocation of funds to their most efficient use** in an economy as, for instance, indicated by risk-return criteria.
- It enables agents to **manage uncertainty** by creating risk-sharing facilities.
- It facilitates **risk pricing** and enables risk to be transferred between different agents according to their ability and willingness to absorb them.
- It offers facilities and markets enabling wealth-holders to **change the structure of their portfolios** of assets and liabilities.
- It deals with problems of **asymmetric information** and the resolution of the resultant moral hazard and adverse selection problems.
- It offers a range of **specialist services**.

These functions impinge on all aspects of the economy and are central to the overall performance of the economy. The efficacy of the financial system in performing these functions is a major ingredient of the efficacy of the economy as a whole. The banking system has a pivotal role in the economy, which distinguishes it from other industries. The banking and financial systems hence perform a unique role.

From a regulatory viewpoint a key issue is the identification of those institutions that have the potential to create insolvency problems for the system as a whole. This is relevant when the failure of an institution can affect the system as a whole which can happen when there is a run on a particular bank. The case for subjecting banks to systemic regulation derives from the nature of the contracts that banks issue on each side of the balance sheet. Several **essential characteristics of banks** entail a need for systemic regulation:

- Banks issue money-certain liabilities on one side of the balance sheet that are used to fund money-uncertain assets on the other side[6]. In other words, a key characteristic of a bank is asset transformation.
- A bank's liabilities can be withdrawn on demand or at short notice. Banks borrow short and lend long to optimise their margin, so they perform a maturity transformation function. This function is necessary in the economy, but it increases the liquidity risk of banks.
- Banks are often responsible for providing liquidity to financial market participants and for ensuring the finality of settlement of large-value financial market transactions on a net and/or gross basis.
- The banking system relies on the confidence of providers of funding in the form of deposits and capital. If there is a run on the bank, a solvent bank can be made insolvent[7]. Since banks are generally known to have similar risk profiles they are prone to contagion, and problems in one bank can easily spread to others, which could result in irreparable damage to confidence in the financial system as a whole.
- Because of the importance of the banking system to the economy government usually cannot allow the banking system to come to much harm. This "implied guarantee" of the banking system by government requires systemic regulation to protect the interests of government and the taxpayer.

These essential characteristics of banks warrant that banks be subject to a systemic regulator or that a close relationship exists between the systemic regulator and the bank regulator.

As banks are the conduit between monetary policy and the financial markets, monetary and macro-prudential supervision operate virtually exclusively through the banks. In contrast the supervision and oversight of investment firms (including fund managers) and insurers rests exclusively on micro-prudential supervision. For investment firms, the prudential supervision typically implies detailed value-at-risk and liquidity-at-risk analyses, but for insurers it rests on the actuarial assessment of these institutions. As investment firms are involved in securities trading for their own account and/or investments on an agency basis, the investment

[6] An insurance company's asset transformation is opposite to that of a bank: it effectively transforms illiquid liabilities into liquid assets.

[7] The argument goes as follows: A solvent bank experiences a withdrawal of deposits following the announcement of the insolvency of another bank. The solvent bank cannot sell its loans at par because of asymmetric information. the selling bank has unique information about the quality of its loans, but cannot transfer this information to buying banks with credibility. The buying bank is therefore likely to demand a substantial risk premium in the form of a discount on the value of loans purchased. This "fire sale" can bring the solvent bank into insolvency.

horizons for such firms themselves are usually short term. Accordingly the prudential requirements for investment firms are focused on short-term price volatility. In the case of insurers, their policyholders and/or shareholders effectively take all actuarial risks on board and the prudential supervision is limited to solvency issues (e.g. the risks flowing from bad management).

The major difference between the supervision of banks and non-banks is the close policy interaction between monetary, macro-prudential and micro-prudential supervision in the case of banks on the one hand, and the virtually exclusively micro-prudential supervision of non-bank institutions on the other. This difference flows from the two functions of money, namely a store of value and a means of payment. Every type of financial institution, including banks, does the first function – i.e. the savings business. However, the second function – i.e. the payments function – is banking *par excellence*[8]. The systemic risk management of the central bank relates primarily to the national payments system, which is the prime function of money and therefore embraces banking supervision in a broad sense: i.e. both macro-prudential and micro-prudential supervision. This means that, at the very least, if bank supervision is not to be the responsibility of the central bank there must always be close co-operation and co-ordination between the central bank and the prudential regulator and supervisor. Appropriate information flows between the central bank and the prudential regulator become crucial in such an environment.

[8] This may well change in the future, as the payments function is bound to change with the proliferation of electronic transfers. Such a development could have major consequences for the regulation and supervision of banks.

Appendix 1.2

The enquiries into competition in the UK

There have been three major enquiries into competition in the UK banking industry. The first (the Cruickshank Report) was established in 1998 by the Treasury and was charged with investigating the general state of competition in UK banking. It was asked to concentrate on banking for SMEs on the grounds that there was a *prima facie* case that competition in this market was not strong.

At the instigation of the Cruickshank view, the government subsequently commissioned the Competition Commission (UK CC) to investigate the particular problems of banking for SMEs. This was one (though not the only) sub-market identified by Cruickshank where competition was weak and constrained. The UK CC took extensive evidence from the banks and produced a ten-volume report in March 2002. It was the most extensive and intensive enquiry ever conducted into this part of the British banking market.

Almost at the same time, Lloyds TSB made a contested bid for Abbey National Bank and this was referred to the UK CC and the bid was subsequently rejected.

In all three cases it appeared that the banks were making excess returns, that competition was weak in some sub-markets (though by no means all), that entry barriers were high in some markets, that banks might be exploiting weak competitive conditions, and that SMEs were particularly affected.

1. Conclusions of the enquiries

Many conclusions and recommendations were made and no attempt is made here to offer a fully comprehensive survey of the conclusions in detail or to relate them specifically to the individual reports. Rather, the main conclusions with respect to competition and profitability are summarised in a way that might be of relevance in any analysis of competition and profitability in the South African banking sector.

The main conclusions can be summarised as follows:

- Compared with many countries, UK banking overall is not particularly concentrated as measured by, for instance, the Herfindahl index and the concentration ratio.
- However, it tends to be highly concentrated in two particular sub-markets: SMEs and personal current accounts with the largest four banks accounting for close on 70 percent of the markets.
- The degree of competition varies considerably across sub-markets. The wholesale markets, the market for large corporate business, the market for personal credit and mortgages and the retail savings market are all highly competitive Competition in the SME sector is highly concentrated but weak in the money transmission business.
- There are high (both natural and imposed) entry barriers to payments systems coupled with high retail costs.
- There are clear entry barriers in some markets in particular in the markets for liquidity management services, and general-purpose business loans for SMEs.
- Oligopoly characteristics such as similarity of pricing, non-payment of interest on current accounts, and differential charging exist in the SME sector. Differential charging amounts to significant cross-subsidies between different classes of customer. With respect to differential charging, free banking in the SME sector tends to be confined to certain categories of SMEs (start-ups and potential switchers after negotiation).
- The effect of this differentiation is to limit effective competition to particular categories of customer, and to prevent the benefits of competition diffusing through to the majority of customers. This amounts to a market lacking in effective competition among suppliers.
- Oligopoly conditions exist in the personal current account markets.
- There is evidence in some markets of practices that restrict or distort price competition including the non-payment of interest on current accounts.
- Limited price competition in some sub-markets and the restriction and situation of price competition has led to excessive prices and profits.
- Sustained excess returns are in part associated with lack of competition in some sub-markets.
- However, some banking sub-markets have become more contestable and new entrants have entered some markets, especially savings accounts for personal customers.
- Competition is not always *effective* in practice (see Chapter 10 below).
- Competition in the credit card market is tending to become more effective.
- However, there is a credit card monopoly position in credit card merchant acquiring business with 85 percent of the market dominated by eight firms and 82 percent dominated by only three firms.
- There seems to be low switching of accounts in both the personal and SME sectors of the market.
- There are significant barriers to switching in some cases.
- Consumers are not always particularly sensitive to price.
- Substantial excess returns (of the order of £2-3.5 billion p.a.) were being earned mainly in

the SME and personal current account markets.
- In the case of SME banking, the high concentration ratio is exploited against the interest of SME customers.
- There is a *complex monopoly* in this sector (see section 2 below).
- There are substantial entry barriers into SME banking with respect to information, bundling, and start-up costs.
- In several markets competition often works by attracting new customers at the expense of longer-standing customers.
- Significant differences often exist between banks for the same product especially in the case of bank overdrafts and credit card interest rates.

The overall conclusion with respect to the SME sector is that:

"SMEs are paying excessive amounts to the clearing banks for the services they receive and/or are receiving inadequate interest…The transfer of resources from SMEs or their customers to bank shareholders, which occurs as a result of the excessive prices, operates against the public interest by restricting SMEs' contributions to a competitive economy, and with adverse effects also on SMEs or their own customers."

The reports note that there are improvements occurring in some markets (due in part to the impact of technology in banking) and more is likely to come in future years. However, the UK CC concluded *"we do not see these developments as substantially increasing competition within an acceptable time scale"*.

2. Scale and complex monopolies

The Competition Commission in the UK is charged with monitoring competition and investigating alleged cases of monopoly, monopolistic competition and restraints to competition. Two concepts are identified: *scale* and *complex monopoly*. A **scale monopoly** exists if one company supplies more than 25 percent of a market. A **complex monopoly** exists if at least 25 percent of a market is supplied by members of a group of persons (which are not interconnected companies) who either voluntarily or not, and with or without agreement between them, so conduct their business that prevents, restricts, or distorts competition.

The *complex monopoly* was found to exist in several areas. It exists where:

- There is restriction of price competition with respect to money transmission charges.
- There is restriction of price competition with respect to business current accounts.
- There is restriction of price competition on smaller, short-term deposit accounts by offering low rates of interest in relation to the value of funds to the bank.
- Banks make a distinction between business and personal accounts and require small firms to have the former whereas it would be cheaper to have the latter.
- Banks give discriminatory discounts through negotiation with the effect that it becomes difficult to make price comparisons and reduces the benefits for customers of competition.
- Banks practice cross-subsidies: i.e., maintain a structure of charges not related to the structure of costs and unduly discriminate between some SME customers.
- Banks fail to promote the scope for savings from use of set-off or sweep facilities to all of the SME customers who could benefit from them.
- Banks fail to provide a regular breakdown of interest charges arising on SME current accounts.

In the case of SME banking, the UK CC concluded that a *complex monopoly* exists and that this operates against the public interest for the following reasons: (i) it allows one of the banks to incur costs significantly higher than would be expected in a fully competitive market resulting in inefficiencies in the allocation of resources, (ii) the four major banks charge excessive prices for services to SMEs in parts of the UK, (iii) it adversely affects the level of choice of banking services to SMEs, and/or (iv) it adversely affects the level of information available to SMEs about among others the payments made on unauthorised overdrafts and the availability and potential savings from use of set-off and sweep facilities[9].

The conclusion is that there is a significant degree of *complex monopoly* in the SME banking market. that this is exploited by the banks to raise the rate of return on the business, and that this operates against the public interest. In particular, the UK CC judged that excess returns derive mainly from the non-payment of interest on SME current accounts (and on shorter-term, smaller savings accounts) while at the same time making charges for money transmission services.

3. Recommendations and remedies of the UK CC report

A series of recommendations were made along with a series of remedies that might be considered for the future. Several were designed to lower barriers to entry and to increase competition where relevant. In terms of the typology outlined above, these amount to measures to increase competition, raise contestability, and improve the effectiveness of competition. In particular, the recommendations included:

- Mechanisms to make error-free switching of accounts easier and less complex for the consumer.
- Measures to limit the bundling of services.
- Measures to improve the flow of information and transparency.

[9] Set-off facilities provide for credit balances on one account to be used to offset debit facilities on another, hence reducing overdraft charges. Sweep facilities allow for automatic transfer of funds between accounts to avoid an account becoming overdrawn.

- An examination to be made of the feasibility of competing banks sharing branches.
- A requirement for the clearing banks to pay interest on the current accounts of SMEs equal to Base Rate less 2,5 percent. alternatively, the banks would be allowed to offer SMEs accounts free of money transmission charges.
- Measures to improve information to customers about alternative suppliers of banking services.
- Measures to improve transparency of bank statements.
- Clarifying the reasons for refusing a loan.

The UK CC usually follows a statement about behavioural remedies with a set of structural remedies in the event that the former prove inadequate. The UK CC made a set of structural remedies for future consideration though judged that, in practice, these would be difficult to construct and might cause more problems than they solved.

4. The banks' responses

Several criticisms were made by the banks with respect to both the diagnosis of excess returns and the recommendations made by the UK CC. They argued that the method of calculating the cost of capital and hence excess returns was flawed in several respects. In particular, the time period adopted was distorting. Thus, in the period 1989-93 negative excess returns were earned by the major banks. Also, the banks claim that the betas used in the CAPM understate the risk of banks. A further point of dispute was the approach of the UK CC in measuring the rate of return on the basis of book-value of capital rather than the much higher figure of market-value. Secondly, the 1990s was particularly beneficial to bank profitability in that it was the longest period in history of uninterrupted growth in the economy. In other words, there had not been a recession in the reference period adopted by the UK CC and hence the cyclically adjusted profitability of banks had been over-stated.

The banks also questioned the interpretation of the results in terms of the well-know survivor bias[10] although the UK CC rejected this line of critique on the grounds that there had not been significant exits from the markets.

Evidence was also given that, even if excess returns had been earned in the past, competitive conditions were intensifying and that this will impact on the future returns of banks.

[10] The "survivor bias" states that only those firms that make returns above the cost of capital survive and so the average returns of the firms that survive is bound to be above the cost of capital.

Appendix 1.3

EU competition policy in the banking sector

This summary on EU competition law, and its application in the EU and SA banking sectors, will be done along the following lines[11]:

1. EU competition law in general

2. Application of EU competition law in the banking sector

3. The application of EU competition rules to South Africa

1. EU competition law in general

EU competition rules may be divided into three categories:

- Firstly, rules monitoring anti-competitive behaviour by undertakings, i.e. cartels and abuses of dominant positions (laid down in Articles 85 and 86 of the EU Treaty).
- Secondly, rules with regard to possible restrictive effects of mergers (Merger Regulation of 1989).
- Thirdly, rules monitoring distortions of competition by governments, i.e. state aid (Articles 92-94 of the Treaty).

In a nutshell, Article 85(1) prohibits agreements and concerted practices between undertakings which restrict competition and may affect trade between Member States. The most obvious examples are price fixing arrangements and market sharing cartels. Such agreements are hard-core cartels and per se illegal. Other agreements or practices, such as exclusive or selective distribution agreements and various forms of co-operation agreements, may also restrict competition. However, under certain conditions these may be exempted from the prohibition under Article 85(1). In essence this will be the case if it can be established that their benefits outweigh their anti-competitive effects. The Commission should be notified of such instances, and in each case it will have to be considered whether or not the requirements for an exemption under Article 85(3) are met.

Article 86 prohibits abuses of dominant positions which may affect trade between Member States. Examples of such abuses are imposing unfair purchase or selling prices or other unfair conditions and tying arrangements.

While Article 85(1) refers to arrangements between several different undertakings, Article 86 relates to unilateral conduct by a single (dominant) firm. Another difference is that, under Article 86 no exemptions can be granted to an undertaking abusing its dominant position.

[11] Based on a speech by M. Negenman, 28 April 1998 and a speech by Commissioner Van Miert, 22 September 1998.

The EU rules on competition fall into two main areas: rules directed at companies (anti-trust rules), and rules directed at public authorities.

1.1. Rules directed at companies

The anti-trust provisions cover all forms of co-operation between undertakings and operations leading to a concentration of economic activities provided that the parties to these operations generate a turnover exceeding certain thresholds. What really matters here is whether they acquire substantial market power or not. If they do not, competition policy concerns will usually be overcome. The Commission can intervene against any abuse that an undertaking makes of a dominant position which it has acquired. A classic abuse is so-called predatory pricing: selling below cost to drive competitors out of the market (e.g. the case of SWIFT vs La Poste in France).

In many fields co-operation between financial institutions is so essential that there would be no product or service available without it. There is a host of technical matters on which participating banks need to agree. The Commission indicated in 1995 that technical co-operation resulting in a more efficient handling of cross border credit transfers raises no antitrust concern. Likewise, the Commission is unlikely to object either to forms of co-operation between payment systems – at least if it leads to increased inter-operability between them.

But where does one draw the line? For example, national and international card systems contain rules aimed at maintaining high standards of security and limiting fraud. At first sight, this would seem to involve genuine technical co-operation. But these rules may well hamper cross border activity by banks who wish either to issue cards to customers or acquire merchants located in another than their home country. The issue then becomes whether or not fraud prevention can be invoked to stop such cross border activity.

1.2. Rules directed at public authorities

The EU Treaty lays down the principle of **prohibition of State aids which could distort competition**[12]**.** However, a certain number of exceptions are allowed. The Treaty also stipulates that undertakings entrusted with particular public service tasks are exempt from the competition rules, but only to the extent that such an exemption is absolutely necessary for them to carry out those specific tasks.

[12] In the case of credit institutions it is possible to use the solvency requirement to arrive at a very rough estimate of the distortion of competition caused by state aid.

The Commission believes that national authorities should, in the common interest, follow a strategy for resolving crises in the banking sector so as to minimise their distorting effect on competition. The policy it advocates is designed to encourage responsible behaviour on the part of the managers of both public and private banks. To that end, it is important not just for the competent authorities to state clearly and publicly that credit institutions will normally be subject to market forces and that banks are no more protected from liquidation than any other enterprises, but also to act accordingly when crises occur. This policy should be accompanied by protection measures for small investors in the form of instruments such as deposit-guarantee funds. It also needs strategies for the orderly liquidation of failed banks with a view to avoiding crises and preventing them from spreading to the rest of the financial industry and the economy as a whole.

The Treaty allows undertakings to be partially excluded from the operation of the competition rules in so far as they are entrusted with public service tasks, or "universal service grounds". For instance some Member States have entrusted certain categories of banks with the task of supplying a comprehensive banking infrastructure covering the entire national territory and consider that task to be a universal service. In these cases the Commission has to examine the merits in great detail before it can conclude whether or not any State subsidy granted to the banks involved can be justified on universal service grounds.

2. Application of EU competition law in the banking sector

Until the beginning of the eighties, doubts remained as to whether Articles 85 and 86 applied to the banking sector. The banks themselves held that their specific position in national economies, influenced by continuous government intervention on capital markets and central bank supervision, excluded the application of EU competition rules. The Commission held the view, however, as expressed in its annual report of 1972, that EU competition law also applied to the banking sector. In 1981, the Court of Justice in the Züchner case, finally settled the debate by declaring EU competition law, without exception, applicable to the banking sector. In this judgement the Court held that banks could not be considered as undertakings entrusted with the operation of services of a general economic interest within the meaning of Article 90(2). Hence, just as any other undertaking, banks have to respect the EU competition rules.

Apart from its formal activities, the Commission has dealt with a considerable number of cases in the banking sector in an informal way, i.e. by means of administrative letters. The most important cases are explained in the respective annual competition reports.

The main orientations of the application of EU law in the banking sector are summarised below, with a distinction made between price competition issues and non-price competition issues.

2.1. Price competition issues

2.1.1. Client fees

Agreements between banks fixing the tariffs charged to clients, whether fixed, minimum or maximum tariffs, are prohibited under Article 85(1), if they affect trade between Member States. Such agreements may not be exempted under Article 85(3). The Commission stated its position with regard to common client fees in several decisions. The position of the Commission was confirmed by the Court in First Instance in 1995.

2.1.2 Interest rates

So far, the Commission has not taken a formal decision with regard to agreements between banks on interest rates charged or granted to their clients. However, it follows from a judgement from the Court of Justice of 1988 (Van Eycke) that interbank agreements on interest rates may also fall within the scope of Article 85(1). An investigation which the Commission undertook in the beginning of the nineties in several Member States shows that, where sufficient proof for such agreements exists, the agreements are unlikely to benefit from an exemption under Article 85(3) regardless of their relation with the economic and monetary policy of the Member State in question.

2.1.3 Multilateral interchange fees (MIF)

Apart from agreements between banks on client fees (i.e. fees relating to the vertical bank-client relationship), banks may also conclude agreements on fees they pay to each other when they co-operate in handling a particular payment, so-called multilateral interchange fees (MIF's). For example, in credit card payment systems the bank of the creditor has to pay a fee to the bank of the debtor. Some payment card operators consider this fee as a remuneration for certain services provided by the debtor bank (e.g. processing or providing a guarantee). Others consider this fee rather as an instrument to restore imbalances of costs and revenues in a four party agreement.

Interchange fee agreements between banks will normally fall outside the scope of Article 85(1) if they are agreed upon bilaterally. However, a multilateral interchange fee is in principle considered as a restriction of competition falling under Article 85(1) because it restricts the freedom of the banks individually to decide their own pricing policies. In addition, this restriction is likely to have a restrictive effect of distorting the behaviour of banks vis-à-vis their customers, since creditor banks who have to pay the fee will normally pass the fee on to the merchants even in the absence of any agreement.

Although an MIF will normally be caught by the prohibition of Article 85(1), it will in principle be exempt under Article 85(3), provided certain conditions are fulfilled. The reasoning is as follows. First of all, the Commission considers that it is entirely up to the banks participating in a payment system to decide how to allocate operating costs of the system and that the banks should thus be free to agree on an interchange fee. The MIF is considered as a legitimate cost-shifting device, which leads to

the best possible satisfaction of the demands from both debtors and creditors. It is found to be a more efficient cost-allocating device than a set of bilateral interchange fees. Therefore, an MIF is found to be exemptible, under the conditions that a) the MIF is the default option and banks can agree on different interchange fees and b) there are no price restrictions in the bank-client relations, in particular no so-called no-discrimination rule (see 2.1.4 below). In addition, in payment systems where there is (almost) no intersystem competition, further conditions may be imposed to guarantee that the banks in question will not set the level of the MIF at an excessive level. In such cases, the Commission might impose a regular review of the level of the MIF by an independent external expert.

2.1.4. No-discrimination rule (NDR)

Contrary to the two other price competition issues discussed so far (i.e. common client fees and MIF's), the Commission has so far not taken a position with regard to the so-called no-discrimination rule (NDR). The NDR is a rule in certain international (such as Visa and Eurocard) and national (such as Cartes Bancaires) payment systems, prohibiting merchants from charging customers for the use of a certain payment system. This rule has already been prohibited by several national Competition Authorities, i.e. in the UK (1990), Sweden (1994) and the Netherlands (1995, confirmed by the Administrative Court in appeal in 1997).

The views of the EU Commission with regard to the NDR may be summarised as follows. It could be argued that the NDR restricts competition since it weakens the bargaining power of merchants vis-à-vis banks when they negotiate the conditions under which they will accept the means of payment offered by a particular payment system. Moreover, an NDR prevents customers from getting a better picture of the relative costs of that particular means of payment. Hence it restricts inter-system competition. Finally, it deprives merchants of the freedom to decide whether or not to pass on the card-using customer one component of their costs (the merchant fee).

Moreover, strong doubts might be expressed on the exemptibility of an NDR under Article 85(3). Although the necessity to protect consumers by ensuring a certain predictability of costs of use of payments systems might be recognized, this predictability should not be achieved at all costs. The NDR could be seen as a disproportionate price to pay in terms of competition since other, less restrictive, means to achieve the purpose exist. There are other means, which are less restrictive than the NDR, to ensure predictability. In particular, merchants could be obliged to publish clearly and in advance (for example by announcements at the entrance of their premises) possible charges for means of payment. Moreover, in order to avoid fluctuations in the amounts charged to cardholders and to avoid abusive surcharges, a cap of charges by merchants could be required. For example, merchants may be required to charge no more than the commission they have to pay to their bank. These two conditions (transparency and ceiling) have been applied in the UK, to the satisfaction of both consumer organisations and merchant organisations. Moreover, the experiences in the Member States where the NDR has been abolished show that the negotiating position of merchants improved and merchant fees actually came down, while at the same time the use of the cards continued to increase. The Commission hopes to clarify its position on the NDR in the near future in the context of some pending cases.

2.2 Non-price competition issues

2.2.1. Access to essential facilities

Of interest from a competition point of view are the conditions for access to payment systems or other financial systems, in particular if these can be considered as essential facilities. The Commission has set out its views on this issue in the earlier mentioned notice on cross border credit transfers of 1995. In this notice an essential facility is defined as a facility or infrastructure without access to which competitors cannot provide services to their customers. A payment system will be an essential facility when participation in it is necessary for banks to compete on the relevant market. In other words, lack of access to the system amounts to a significant barrier to entry for a new competitor.

In its notice the Commission set out that membership criteria of an essential facility should be objectively justified, i.e. written, accessible and non-discriminatory. For example, the requirements for members concerning their financial standing, technical or management capacities, and compliance with a level of creditworthiness all need to be explicitly stated. The payment of an entry fee may also be required, but must not be set at so high a level that it becomes a barrier to entry. The level of an entry fee must not exceed a fair share of the real cost of past investments in the system. The membership criteria may not make membership in the system conditional upon acceptance of other unrelated services. Refusal of membership to an essential facility should be accompanied by a written justification for the reasons for the refusal and should be subject to an independent review procedure.

2.2.2. Co-operation agreements between banks

The Commission acknowledges the importance of co-operation between banks to some extent, in order to provide improved services to consumers and in order to promote the integration of the Community's banking systems. Article 85(1) will not apply if banks agree on certain technical forms of co-operation in a payment system. For example, this will be the case for agreements relating to common banking hours, clearing rules, setting up a direct debit scheme and guidelines contributing to the security of a payment system.

Forms of co-operation between banks beyond purely technical co-operation will in principle be restrictive of competition. However, where restrictive co-operation arrangements between banks promote efficiency, such arrangements may be exempted from the prohibition under Article 85(1), provided

that they are no more restrictive than necessary to achieve their objectives.

2.2.3. Prohibition on participants from adhering to other payment systems

The following case is an illustration of another non-price competition issue. In 1996 the Commission received complaints from American Express and Dean Witter, the issuer of the Discover Card, against a rule proposed by Visa that would have banned its members from issuing some competing cards in Europe. The proposed rule was based on an existing Visa USA rule.

The Commission's Competition services considered that the proposed rule, if adopted, would have fallen within Article 85(1) because it would have restricted competition between payment card systems as well as between banks offering international general purpose cards. This can be explained as follows:

- First, the proposed rule would have led to a restriction on inter-system competition: it would have substantially restricted competition between global general purpose card systems by impeding card systems other than Visa from licensing the vast majority of EC banks as issuers since Visa includes a substantial majority of the major European banks as its members. If the rule had been adopted, it was unlikely that any of those banks would have risked exclusion from Visa membership because they derive substantial revenue from it, and would lose substantial actual and potential sums were this membership sacrificed (market foreclosure effect).

- Secondly, the rules would have restricted competition between banks by decreasing the broad range of products they could present to customers. A range of different cards may enhance the services of banks to customers and increase their ability to target particular market segments.

After Commissioner Van Miert warned publicly that Visa's proposal could not be accepted, the EU Board of Visa International decided to drop the proposal. As a consequence, the complaints were withdrawn and the investigation was closed without the Commission taking any formal action (annual competition report 1996).

2.2.4. Restrictions on cross border services and exclusivities

Some payment systems restrict the freedom of their member banks to provide cross border services, i.e. issuing cards to cardholders in other Member States and/or acquiring merchants for card transactions in other Member States. Some payment systems allow their member banks to provide cross border services only when they have established a branch or subsidiary in the territory concerned. Moreover, in some payment systems, banks are allowed to acquire an international merchant for all its activities within the EU only if this merchant falls within certain limited categories, such as car rental companies and international hotels (so-called central acquiring). Merchants falling outside these categories, such as for example large retailers and petrol companies, may not be centrally acquired by one bank for all their EU transactions but they will have to conclude contracts with banks in several Member States. Naturally, this will not only restrict the commercial freedom of action of the banks participating in the payment system at stake. It will also have a restrictive affect on the freedom of merchants who are restricted in shopping around for the supplier of payment card services of their choice.

In addition to these restrictions on cross border services, banks in certain Member States hold an exclusive licence to acquire merchants within their territory. In other Member States, merchant acquirers in some payment systems hold a *de facto* monopoly. Naturally, these exclusive rights have a restrictive effect on intra-system competition.

The Commission is currently investigating these issues in some pending cases and hopes to clarify its position in the near future.

3. The application of EU competition rules to South Africa

To a large extent South African competition law is in line with the EU. Although industrial countries have fairly uniform competition policies, there are country specific factors that at times call for a different approach by the Competition Commission in South Africa. In this area the following issues are of importance:

- **The National Bank Account (or a basic bank account for unemployed or informally employed unbanked individuals)**.

  A proposal from the Banking Council of SA suggests that a basic bank account could be supplied if all the banks fix certain fees and charges.

  This arrangement would be prohibited under EU rules, unless the pricing of the National Bank Account would be subjected to oversight by the competition authorities. The South African Competition Act also prohibits such collusion by competitors to fix prices, terms or conditions, according to section 4(1)(b)(i). The only way around this prohibition would be for the parties to the agreement to apply for an exemption in terms of Section 10 of the Act. In this case it would seem that the only basis for an exemption would be that provided for in section 10(3)(b)(iv), where an agreement in contravention of the Act might be exempted if it contributed to "the economic stability of any industry designated by the Minister, after consulting the Minister responsible for that industry".
- **Access to the National Payment System**.
  Because South Africa does not have a tiered banking system, competition in the National Payment System may be impaired by the

powerful position held by the Big Four[13] banks in the payments system.

- **Market power of exchanges over the clearing and settlement systems.**
  The EU is currently investigating whether exchanges, clearing and settlement houses should be separate companies (i.e. vertically separated from trading platforms rather than vertically integrated). Preliminary indications are that a crucial issue will be whether these exchanges are organised as "mutual associations not-for-profit" or as "for-profit companies". In South Africa no decision in this respect has been made yet, as all exchanges are still organised as mutual associations. It should be noted though that the banks are the major (nearly sole) shareholders of these exchanges.
- **State subsidies for the under-banked**
  For the public sector it would be of great benefit if every citizen had a bank account, for which there are both private and social benefits. The private (individual) benefits of access to banking services include the ability to save and to build financial buffers against adversity, as well as reducing the costs associated with making payments without banking facilities. Social benefits (i.e. benefits for society as a whole) include reduction of theft, improved mechanisms for social transfers and other remittances (including tax and benefit remittances) and improved economic linkages to rural and deprived communities. Estimates based on the infrastructural costs of high street banks suggest that serving the unemployed and informally employed may be unprofitable for these banks (see Chapter 4). Third and second tier banks may be in a better position to serve this customer base.

  Over and above this, the Government may decide that it is worthwhile to subsidise such bank accounts, if there are spill over benefits to be had from increased access to banking services. Only if such subsidies are offered to the banks on a tender basis are they likely to justify an exemption in terms of the EU competition rules.

[13] The Big Four refers to the 4 largest banks in South Africa, namely ABSA, FirstRand, Nedcor and Standard Bank.

Chapter 2

International comparisons of competition and profitability

This chapter consists of the following sections:

1. Aspects of international banking systems.
2. Brief overview of the South African banking system.
3. Market structure of the South African banking industry.
4. Profitability of South African banks.
5. Returns of banks and non-banks.

The relation between competition and profitability in the banking industry provides a means of comparing the banking industry in different countries. However, it is not a simple relationship: while low levels of competition enable incumbents to earn very high margins; efficient banks may also achieve high levels of profitability.

Competition needs to be understood within the framework of contestability where suppliers are able to enter a market freely if existing suppliers do not price competitively. Hence, in a highly contested market, the barriers to market entry are sufficiently low so that new players can enter quickly; undercut inefficient incumbent suppliers, while also being able to exit just as quickly, resulting in an incentive for suppliers to operate efficiently (Wallis, 1997, p.601).

This chapter provides an overview of the data on the banking sectors in South Africa and other selected countries. The analysis here is based on overall rates of return. However, firms' profits are generated in submarkets, where competitive and consumer behaviour as well as profitability varies. This discussion is further expanded in Chapter 3.

The conclusions of this analysis are as follows:

- South African banks have outperformed their peers in terms of profitability over a sustained period, but the differential has narrowed in recent years as average returns of international banks have increased and operating costs have increased locally.
- South Africa's top five banks perform well in terms of international benchmarks of efficiency and non-performing loans.
- The market share of assets of South Africa's big five banks[1] remains high, as foreign entrants and niche banks have entered and exited the market.
- Based on time deposit rates and the prime rate of interest, South Africa's interest spreads are comparable with other emerging markets. Many low-income consumers receive substantially less than the published time deposit rate, however.
- When compared with other non-bank South African firms, the variability of returns in the banking sector is low. This suggests that banks have greater ability to secure margins over the course of the business cycle.

[1] SA's Big Five include ABSA, FirstRand, Investec, Nedcor, Standard Bank

2.1 ASPECTS OF INTERNATIONAL BANKING SYSTEMS

The overview attempts to place South African banks in an international context. The focus is on the number of banks, the efficiency of the sector and the return from banking business. In the graphs South Africa's top banks are compared with other top global banks.

Comparisons of this sort can be undermined by country specifics. For example, of the developed countries chosen here, it may be argued that the UK, Luxembourg and Germany all constitute special cases[2]. In addition, countries such as the Czech Republic and Poland were deliberately excluded, on the grounds of exceptionalism, even although in other areas they might be seen as comparable with South Africa. In addition, comparisons are sensitive to the period chosen. In spite of these caveats, the strong requirement for international benchmarks necessitates the exercise. The source of the data and the year have been standardised: The data here are from *The Banker*, and are for the year 2002, unless otherwise stated.

The **number of banks** in a country varies widely, as a consequence of the size of the economy, history, and barriers to entry. In 2000, there were some 2819 registered banks in Germany and 54 in Greece. At the time, there were some 44 banks in South Africa, with a further 14 branches of foreign banks. The number of banks in South Africa is relatively low compared to some of the European countries shown[3].

Definitions of banks vary from country to country and some have many substitute providers such as building societies or co-operatives. In South Africa, there are few substitute providers for retail services and small businesses.

It is worth noting that small numbers of banks can generate competitive outcomes, so long as players are constrained in pricing behaviour by the presence of other players in the market or by the threat of entry. This will be explored further in Chapter 3.

The **number of banks rated in the world's top 1000** is shown in Graph 2.1.2 for a selection of emerging and developed economies. The ranking of the top 1000 banks is based on tier one capital[4], which is seen as an indication of strength. While five of South Africa's banks are in the top 1000 and nine Thai banks also fall into this category. **The combined tier one capital of the five South African banks is relatively small and is equivalent to that of the 59th bank in the world** (The Banker, 2003).

Efficiency in the supply of banking products, as in other industries, is assumed to ensure that consumers pay fair prices for products and the economy's scarce resources are allocated to their highest value uses (Wallis 1997: 601). In the banking industry, technical efficiency is often measured by expressing operating expenses as a percentage of total income. The current international benchmark of 60 implies that banks with a ratio of over 60 are considered inefficient. At 60.3, the cost to income ratio of South Africa's top banks is in line with the international benchmark. It also compares favourably with a selection of developed and emerging market economies shown in Graph 2.1.3. South Africa's top banks outperform those in Italy, Thailand and Brazil, but do not appear to be as efficient as the top banks in New Zealand and Australia, for example.

Another measure of the efficiency (and stability) of the banking industry is the level of **non-performing loans to the total loan book** in Graph 2.1.4. The ratio of South Africa's non-performing loans to total loan book appears to be moderate, roughly in line with that of UK, Hong Kong and Italy. **Comparisons suggest that South Africa's exposure to non-performing loans is in line with relatively mature banking industries,** rather than other emerging economies such as Indonesia and Thailand.

The **profitability of industry** participants is sometimes used as an indicator of the underlying level of competition in a particular market, even though the link between concentration and profitability may not be straightforward. The data shown in Graph 2.1.5 are the **return on assets** for each country's top five banks. The pre-tax return on assets in South Africa's top banks is roughly in keeping with other top banks around the world, at around 1.5 %.

The data for **return on equity** in Graph 2.1.6 present a favourable picture, with **South African banks out-performing all but two comparative countries, New Zealand and Indonesia.** At just over 30%, the returns of the top banks in South Africa exceed those of the UK and US as well as other emerging markets.

South African results may be compared with those of Australian banks, who have achieved roughly the same returns. At the end of 2001, Australia had 51 banks, of which 25 were commercial and 26 foreign, as well as 18 mortgage credit institutions and a further 205 credit co-operatives (OECD, 2003).

In South Africa there were 39 registered banks and 15 local branches of foreign banks at the end of 2001 but by the end of 2003 this had fallen to 23 and 15 respectively. This has much to do with the demise of the smaller banks discussed in Section 2.2.

The Australian banks achieved only slightly lower returns than South African banks but were significantly more efficient, with lower levels of non-performing loans. Given the greater number of players in the Australian market, it could be concluded that their high returns are a result of efficiencies induced by competition. In South Africa, there may be other underlying factors for the high returns.

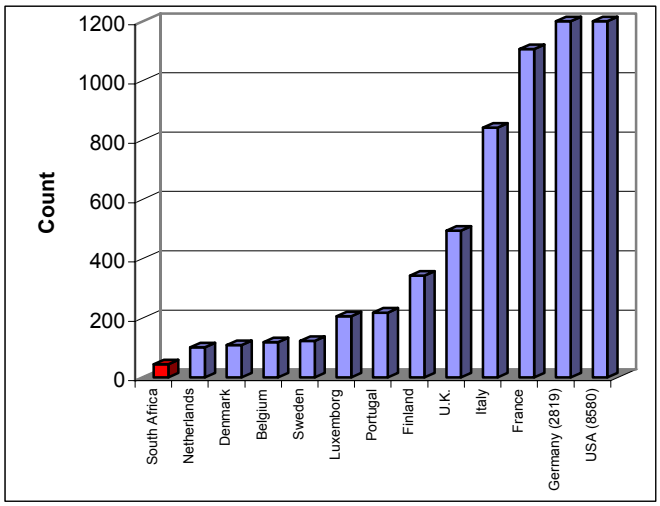
Profitability and efficiency vary with the business cycle and data for a single year may be misleading. In Section 2.2 South African data for over the period of a cycle will be presented.

[2]UK is a financial centre; Luxembourg, a tax island and Germany has a three tier banking system wherein first tier commercial banks serve large firms, second tier state banks serve small businesses and third tier sparkasse (or building societies) serve consumers.

[3] A brief description of the South African banking sector is provided in Section 2 of the Introduction.

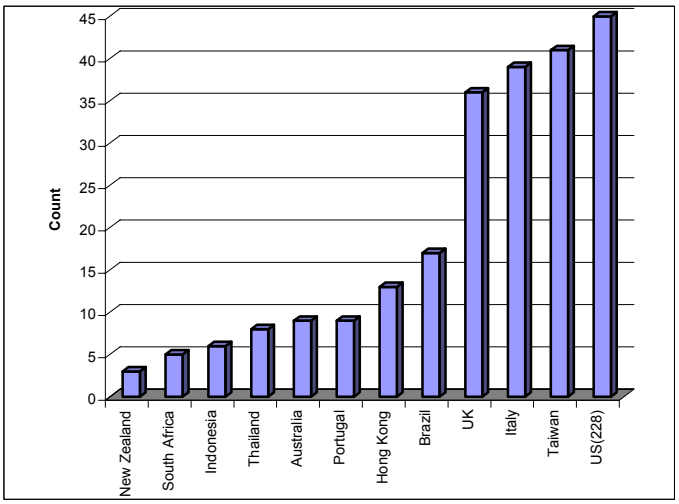
[4] Tier one capital is shareholder equity, whereas second tier capital refers to bonds.

Graph 2.1.1 Number of banks by country, 2000



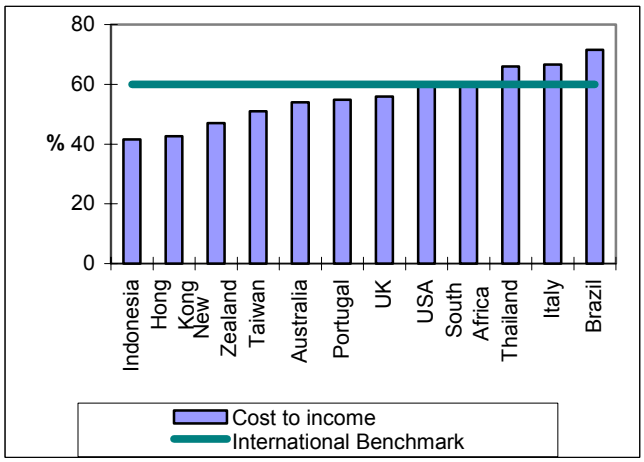
Source: Llewellyn, 2003. Bank Supervision Department

Graph 2.1.2 Number of banks in Global Top 1000, 2002



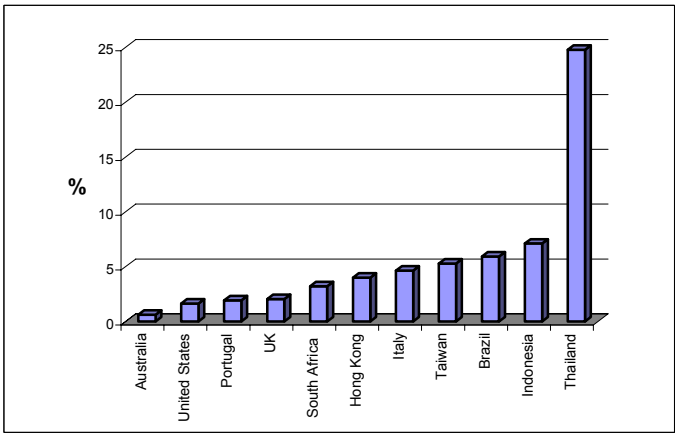
Source: The Banker July 2003

Graph 2.1.3 Efficiency: Cost to income ratios, 2002



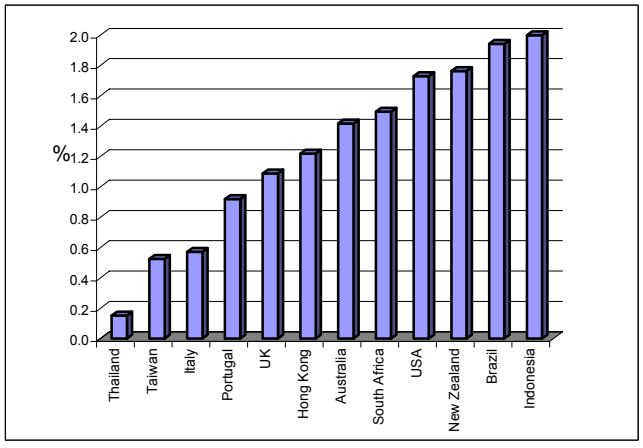
Source: The Banker July 2003

Graph 2.1.4 Non-performing loans as a percent of total loans, 2002



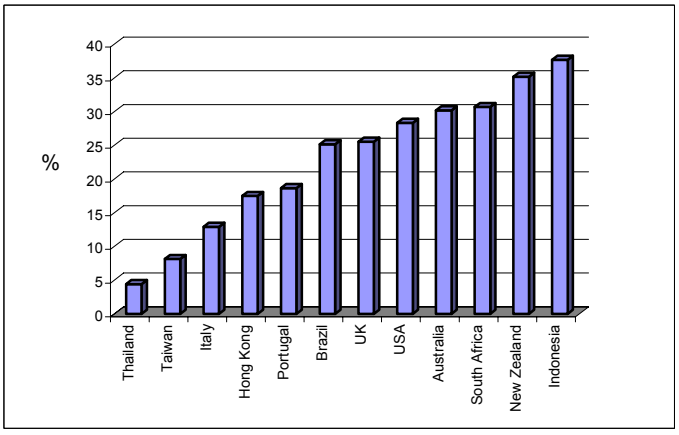
Source: The Banker July 2003

Graph 2.1.5 Return on assets



Source: The Banker July 2003

Graph 2.1.6 Return on equity



Source: The Banker July 2003

2.2 BRIEF OVERVIEW OF THE SOUTH AFRICAN BANKING INDUSTRY

Over the past decade, the South African banking industry has witnessed major structural and regulatory change. After 1994, there was increasing competition from niche players and foreign entrants, as technology and financial liberalisation created the stimulus for competition from new areas. In addition, the sector has been subject to changes regarding new regulation, compliance and transparency. The process of democratisation has also required banks to examine the extension of services to South Africans excluded from formal banking.

The **number of fully registered banks** in South Africa increased steadily from 35 in 1994 to a peak of 44 in 2000. (See Table 2.2.1 and Figure 2.2.1.) This was associated with liberalisation of the external account and relaxation of banking regulations regarding foreign participants.

In 2001 and 2002 the number of locally registered banks fell to below pre-1994 levels. The fall in numbers in recent years has been associated with the decline in the smaller A2 banks[5]. There are several reasons for this: Some A2 banks were acquired by larger banks as part of the consolidation going on in the industry, including Imperial bank, Mercantile Lisbon and McCarthy bank. Others dissolved for reasons of poor financial management such as Regal Treasury bank and SAAMBOU (the seventh largest bank in terms of assets at the time), and yet others, such as Brait Merchant Bank, Cadiz Investment Bank and Corpcapital bank, did not apply for renewal of their licences at the end of 2002. **This latter group surrendered their licences, as the benefits of retaining a banking licence no longer appeared to outweigh the costs associated with it.** In addition BOE, the 6th largest bank, was absorbed by Nedbank towards the end of 2002/2003.

The cost-to-income ratios of the entire banking sector increased as new players established themselves after 1994 and faced start-up costs, but started to improve in 1997. (See Graph 2.2.2.) In recent years, increasing consolidation, which involved merger and other costs, together with new accounting and compliance regulations, have had a **negative effect on efficiency** in the industry. Since 2000, operating expenses have grown more rapidly than industry income. For example, while total income grew by over 5% in 2002, expenses grew by 9.6%.

The discussion above suggest that while the cost-to-income ratio is appealing it is not a perfect measure: Both the entry and exit of banks have lead to increased operating costs. This is because the cost-to–income ratio is a composite measure. In addition, when institutions have market power, for example, they may be able to increase income at a faster rate than costs; hence an improvement in the ratio may mean a worse, rather than better, deal for consumers. This will be further explored in Chapter 3.

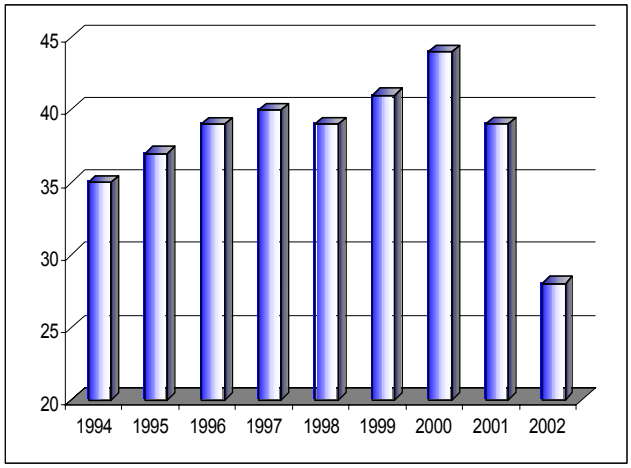
The increase in operating costs has had a negative effect on profitability ratios over the past two years. In Graph 2.2.3 **return on assets before tax** are shown for South African banks together with the average ROA for the global Top 100 banks. Prior to 1999, the return on assets of South African banks is roughly twice that of the average before tax return on assets for the world's top banks. Thereafter the gap narrows, so that in 2002, the return on South African banks is only marginally above that of the Top 100. Apart from an increase in operational costs, in recent years, the local banking industry has survived a number of shocks, including the demise of A2 banks as well as the listing of Investec on the London Stock Exchange. While listing abroad may have brought other advantages in terms of disclosure to stakeholders (see Chapter 10), the relatively poor performance of Investec as one of SA's biggest banks, has also had a negative impact on average industry returns.

In order to allow international comparison, the data in Graph 2.2.4 show **pre-tax returns to tier one capital** for South African banks and the world's top 100. As for the return on assets, the return of South African banks has exceeded that of the Top 100 banks until 1999. Thereafter, between 1999 and 2001, South African returns were lower than that of the Top 100 banks. South African banks out-performed the top 100 in 2002. Of course, this benchmark does not account for exchange rate or inflationary risk, which is further explored in Section 2.5.

The data in Table 2.2.1 provide a brief overview of the **growth of the South African banking industry.** The numbers of registered (and fully locally capitalised) banks as well as branches of foreign banks are shown. The growth in the number of players is associated with the growth of the banking industry's assets and the growth in loans and advances. On average, **the loans and advances of the banking sector make up around 65% of its assets over the period under review.** The average growth in banks' assets (15.9%) has exceeded the economy's nominal growth rate (11.1%) over this period, and loans and advances have grown from around 57% of GDP in 1994 to 73% in 2002. In Brazil where loans are a scant 25% of GDP, banks are seen as inhibiting economic growth (*Economist*, 2003). This is clearly not the case in South Africa.

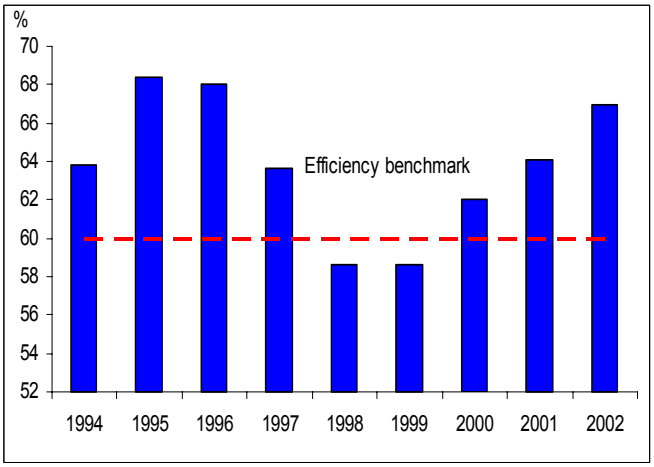
[5] The term A2 banks is a term applied by the ratings agencies to the smaller SA banks (essentially all local banks except the Big Four and Investec).

Graph 2.2.1 Number of South African registered banks



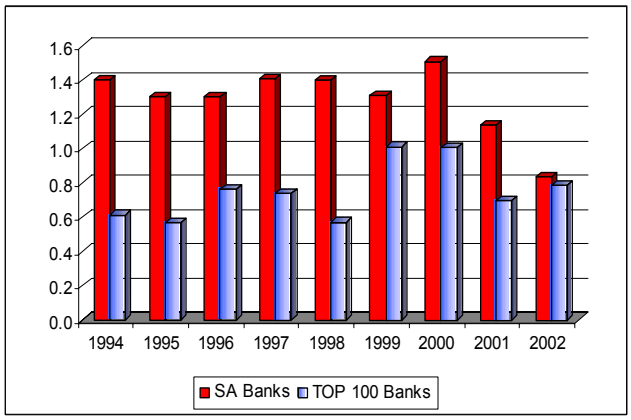
Source: Bank Supervision Department

Graph 2.2.2 Efficiency of South African banks



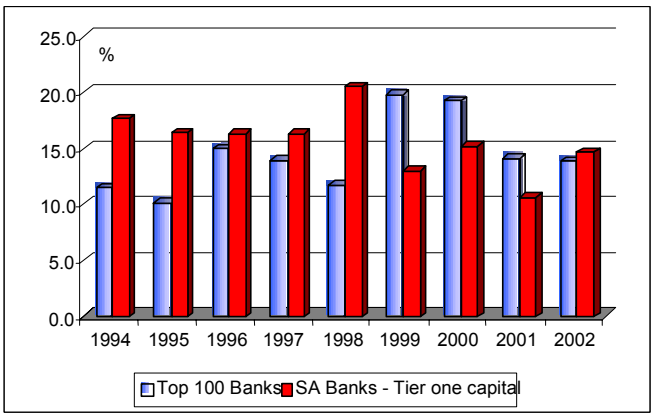
Source: Bank Supervision Department

Graph 2.2.3 Return on assets - South African banks



Source: Bank Supervision Department, The Banker 2003

Graph 2.2.4 Return on tier one capital - South African banks



Source: Bank Supervision Department, The Banker 2003

Table 2.2.1 Growth of the South African Banking Industry

	Number of registered banks	Number of branches of foreign banks	Value of Banking sector assets R billions	Value of loans and advances R billions	Growth in bank assets	Growth in Nominal GDP	Value of Assets as a % or GDP	Loans and advances as a % of GDP
1994	35	6	R 344.20	R 270.80	16.8%	13.1%	71.4%	56.2%
1995	37	4	R 399.10	R 315.29	16.0%	13.7%	72.8%	57.5%
1996	39	6	R 472.10	R 372.96	18.3%	12.7%	76.4%	60.4%
1997	40	9	R 550.50	R 440.40	16.6%	11.0%	80.3%	64.2%
1998	39	12	R 654.80	R 510.74	18.9%	7.8%	88.6%	69.1%
1999	41	12	R 728.00	R 554.74	11.2%	8.4%	90.9%	69.3%
2000	44	15	R 819.00	R 612.61	12.5%	10.9%	92.2%	69.0%
2001	39	15	R 1,049.90	R 732.83	28.2%	10.7%	106.8%	74.6%
2002	28	14	R 1,100.70	R 800.21	4.8%	11.8%	100.2%	72.8%

Source: SARB Quarterly Bulletin, Bank Supervision Department Annual Reports

Although regulatory barriers to entry are appropriate to ensure protection of depositors and financial stability, these should distort competition as little as possible with barriers, including entry and authorisation criteria, being proportionate to the risks posed (Cruickshank, 2000: 14). As noted in 2.1, regulations that lowered entry barriers facilitated the access of new players in South Africa after 1994. This has stimulated the role of the sector in the economy and briefly affected the **market share** of the incumbents.

Evaluations of **market share** and concentration require that the market be defined so that the number of competitors within that market can be established. It is increasingly becoming accepted that the market should be defined at product rather than firm level. Once the basis of analysis shifts from firm to product it is clear that in some sub-markets there may be non-bank competitors such as retailers issuing their own credit cards. This will be explored further in Chapters 5 and 8.

Nonetheless, as a benchmark, market share comparisons based on assets of banking firms are very common. The data in Figure 2.3.1 show the market share of assets for the top three and top five banks in a selection of countries, in 2001. While the dominance at firm level is greater in South Africa than for countries such as the UK and Germany[6], it is lower than for Finland where the top 5 banks account for 96% of the assets of the industry and Belgium where the top 3 banks account for 90% of the industry.

The **market share** of the top banks in South Africa has waxed and waned in response to changes in the number of foreign and niche banks entering the market. The data in Graph 2.3.1 show that in 1994, the top 3 banks (ABSA, Standard and FNB) accounted for 69% of the market share of assets. By 2001, this had slipped to just under 56%. Similarly the share of assets of the top five (including Nedcor and Investec) declined from 87% to just over 75%. By 2001, niche and foreign banks accounted for around 25% of the industry's assets.

The analysis of market share at product, rather than firm, level shown in subsequent chapters suggests that the shift in assets has occurred mainly in the corporate market segments, with little change in the domination of retail services by the biggest banks.

By December 2002, after the demise of some smaller banks, the share of assets of the top 5 banks increased to 80%.

Although price competition plays a limited role in the banking industry, price remains a useful indicator of competition[7], one possible measure of which is the **interest spread** or the difference between the lending rate and deposit rate. The data in Graph 2.3.2 show the lending and deposit rates for a number of countries. These data are at best indicative, with the best comparable rates used. In general, the lending rate is the prime rate and the deposit rate refers to that for short-term time deposits.

In the case of South Africa, the 88-91 day notice deposit rate with the Big Four banks has been used. South Africa's interest rate spread is compared to an average annual spread of eight emerging and developed countries: Australia, New Zealand, Italy, Portugal, Indonesia and Thailand.

The data show that apart from 1998 and 1999, when the South African spread was significantly higher, the interest rate spread in South Africa is not dissimilar to that in a selection of emerging market and other developed countries. Over the period 1993-2002, the average spread for South Africa is 4.8 percent and for the benchmark countries, 4.4 percent. This difference is more marked if one compares South Africa with European countries in terms of the rate on current account overdrafts rather than prime. In addition, **the deposit rate that the average South African receives is substantially lower than the time deposit rate** published by the Reserve Bank. Hence the interest spread varies depending on income profile of the client. This will be explored more fully in Chapter 8.

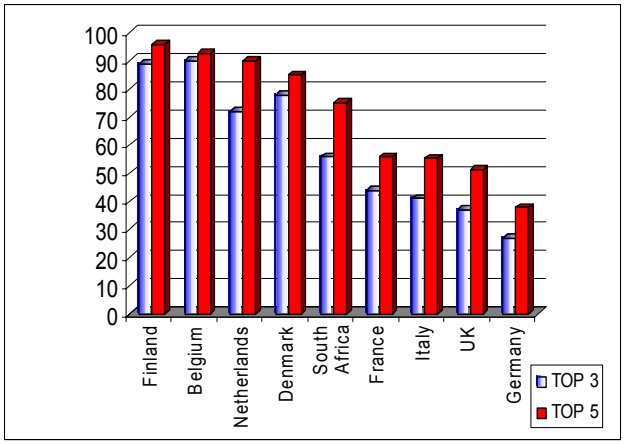
Another way of examining the prices of the banking industry is through the **interest margin**, which reflects the intermediation function by banks. The interest margin is defined here as interest income less interest expenses and will be expressed as a percent of the value of advances. In Graph 2.3.3, the data for the interest margin for South African banks is plotted together with the interest rate spread. The data show that the ratio of the interest margin to advances is generally just under the 4% level, except in 2001 when it increases to 4.6%. On average over the period, it is at 3.85%. While the margin falls back from its high in 2002, it remains to be seen whether it will again increase in 2003. Towards the end of 2002, after the fall-out in the industry, the Registrar of banks noted that there was a strong increase in the interest margin, to 3.8% from an average of 3.2% during the year (Bank Supervision Department, 2002). This may reflect market power to extract a higher margin. This will be explored in Chapter 3.

The data in Graph 2.3.3 also show that in the years when the interest rate spread was greatest, in 1998 and 1999, the interest margin did not increase. During these years, which represented the trough of the business cycle, the volume of interest-bearing deposits and loans may both have decreased, undermining the value of the large spread charged by the banks.

[6] As indicated in footnote 2

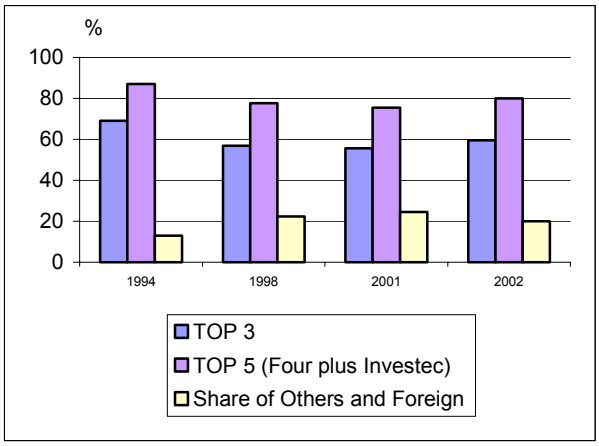
[7] Wallis, 1997, p.461.

Figure 2.3.1 Market share of Top banks: Selected countries 2001



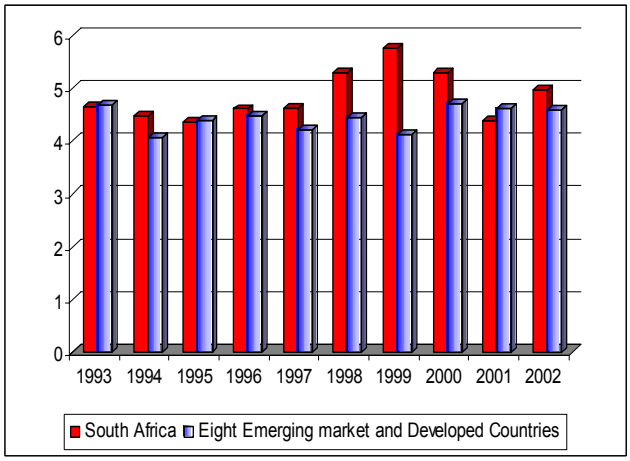
Source: Llewellyn, 2003, Bank Supervision Department, KPMG Banking report

Graph 2.3.1 Market share of assets for select years: South African banks



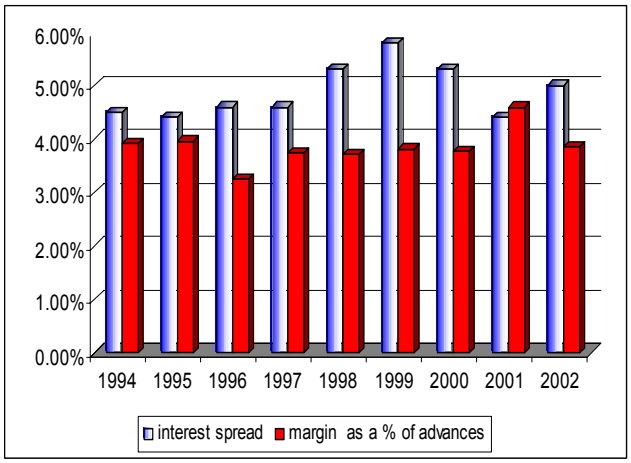
Source: Bank Supervision Department, KPMG Banking report

Graph 2.3.2 Interest rate spread: South Africa and average of eight emerging and developed countries



Source: MacGregor BFA

Graph 2.3.3 Interest rate spread and interest margin: South African banks



Source: Bank Supervision Department, MacGregor BFA

2.4 PROFITABILITY OF SOUTH AFRICAN BANKS

The link between profitability and concentration is not straightforward[8]. High levels of profitability due to inadequate competition may produce one or both of the following results:

- Higher returns to the firms' shareholders than a competitive market.
- Return on equity in excess of its cost[9].

However, measurement of the profitability of banks or other firms against what an effectively competitive market might produce is difficult. In this section, and the one following, we explore the profitability of the banking sector. This section examines the returns to banks over the business cycle, with a brief international comparison and the following section compares returns of banks and non-banks, since comparing trends with other stocks is potentially revealing.

The analysis is over an entire business cycle as economic downturns tend to increase exposure to bad debts and this may affect results. In the graphs data are shown from 1993, the end of a downturn. According to the South African Reserve Bank (SARB), this was followed by an upturn that peaked in November 1996, and a downturn with a lower turning point in August 1999. The South African economy is still deemed to be in an upturn and the data thus show more than a complete cycle.

The **pre-tax profits** of South African banks listed on the Johannesburg Securities Exchange SA seen in Graph 2.4.1 showed a steady increase between 1993 and 2001, before falling sharply in 2002. The latter development included the consequence of bringing to account losses incurred in banks' micro-lending operations, such as ABSA's Unifer. The **average effective tax rate** of listed banks (tax paid expressed as a percentage of pre-tax profits) fell to a low of 7,4% in 1996, before rising to 19,2% in 2001. The initial decline in the average rate can probably be ascribed chiefly to reductions in the corporate tax rate and the Secondary Tax on Companies, while the sharp increase since 1996 is due to factors such as the SA Revenue Service's efforts to bring structured finance packages and other instruments used by the banking sector to reduce tax liabilities, into the tax net.

The data in Graph 2.4.2 show that nominal **after-tax profits** increased at an exponential rate between 1993 and 1999, before slowing down. **There was either no obvious response in profitability to the cyclical downturn in the economy after 1996,** or banking profitability lags the business cycle by two years or more. Deflating after-tax profits to constant 1995 price terms using the deflator for Finance, Insurance and Real Estate derived from Reserve Bank's national accounts graphs, **profits of the banking sector increased in real terms by 319% between 1993 and 2001, and by 114% over the course of the study period.**

The average **return on equity** of listed South African banks is contrasted with an international benchmark derived from the return on average capital of the world's Top 100 banks in Graph 2.4.3 The benchmark was obtained by weighting the returns of the international banks by their respective tier 1 capital (as published in *The Banker*). It reveals that the **average returns on equity of South African banks was – with the exception of 2002 – consistently higher than the weighted average for the world's leading banks over the study period.** While the margin of difference between South African and international returns on equity has narrowed in the past four years, this appears to be due as much to an increase in the average returns of international banks as a decline in those of South African banks.

Because of the potential distortions caused by inflation (which inflates returns at a higher rate than equity), an **inflation-adjusted, after-tax return on equity** is included in Graph 2.4.4. The adjustment is effected by subtracting an inflation adjustment to the depreciation of other fixed assets from after tax profits, and by adding surplus market value or directors' valuation of all long-term investments, and an adjustment to the book value of other fixed assets to the total owner's interest. The basis for the inflationary adjustment is the component of the Production Price Index that reflects costs of machinery and equipment. As is to be expected, the difference between the inflation-adjusted and the unadjusted graphs are more marked during the earlier part of the study period, when inflation rates in South Africa were higher.

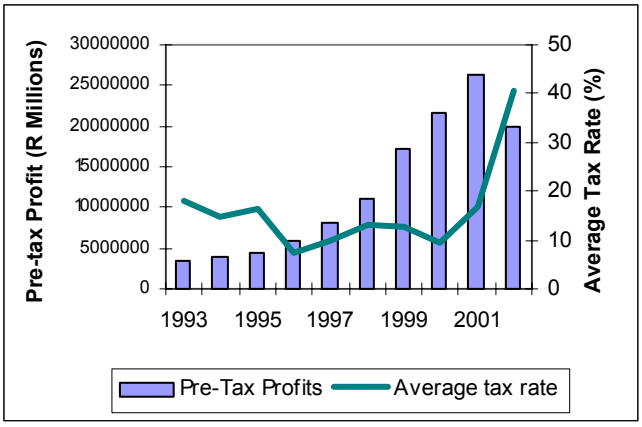
Graph 2.4.5 suggests that inflation-adjusted returns on equity are contra-cyclical – tending to peak at the lower turning points of the **business cycle**, and reaching a lower turning point at the end of a cyclical upswing. Since it is to be expected that interest margins and fee income will not be under particular pressure at times when the economy is in a cyclical upturn, this trend is probably due to growth in the capital base of banks during this phase of the cycle. It is suggested that the sharp downturn in the return on equity in 2002 is also something of an anomaly, due mainly to losses in bank micro lending operations being brought into account.

A comparison of the returns on equity of banks and the **interest rate cycle** (represented by the prime overdraft rate) in Graph 2.4.6 does not indicate a clear relationship. Returns slowed down when interest rates rose sharply in 1995, but recovered in 1996 when the rise in prime was more moderate. The rise in returns was more marked in 1999 - when prime dropped sharply - but declined marginally in 2000 when there were significant further reductions in the prime overdraft rate. This suggests that **it may not be the level of interest rates, so much as their volatility, that impacts on banking returns.**

The data shown here suggest the banking sector is able to secure consistent profits of the business cycle.

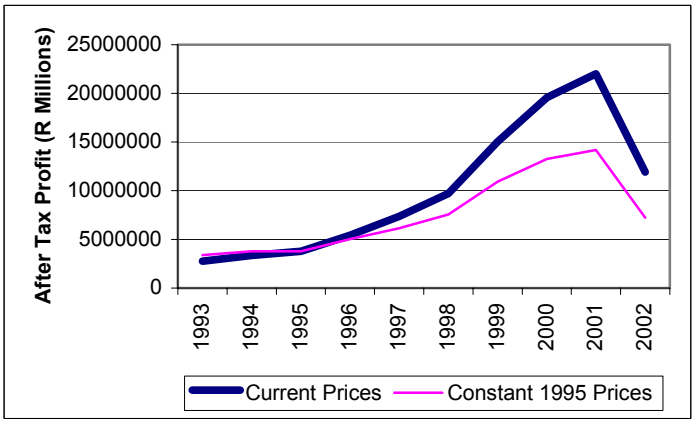
[8] There is no conclusive evidence from international studies on the subject.
[9] Cruickshank, 2000.

Graph 2.4.1 Pre-tax profits of the South African banking sector



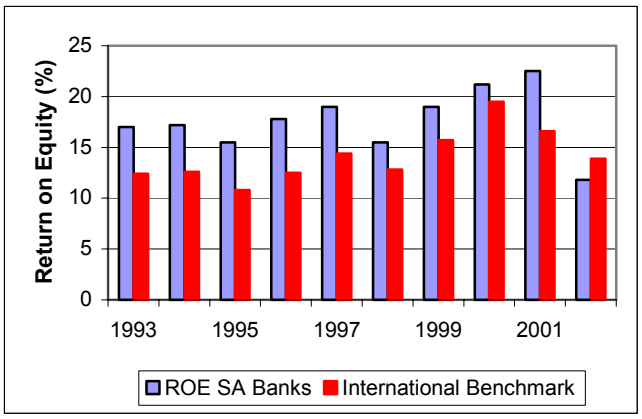
Source: McGregor BFA

Graph 2.4.2 After tax profits of the South African banking sector



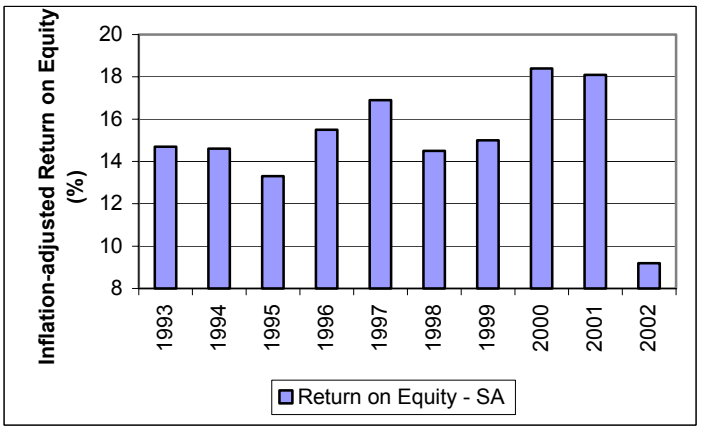
Sources: McGregor BFA, SARB

Graph 2.4.3 Return on equity of SA Banks against international benchmark



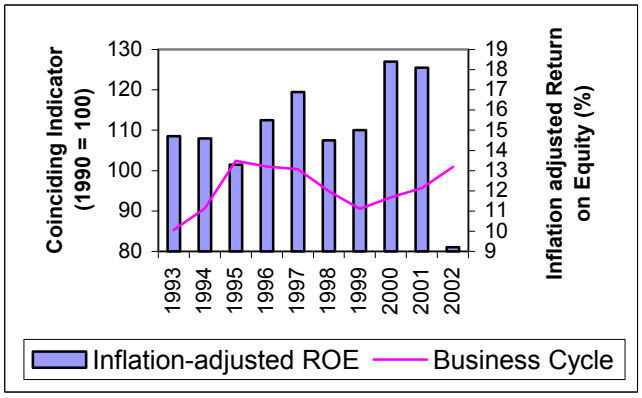
Source: McGregor BFA, The Banker

Graph 2.4.4 Inflation-adjusted return on equity of SA banks



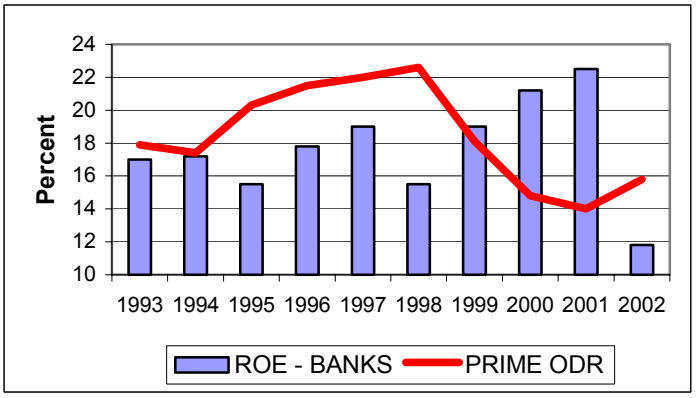
Source: McGregor BFA

Graph 2.4.5 Inflation-adjusted return on equity of SA banks and the business cycle



Sources: McGregor BFA, SARB

Graph 2.4.6 Return on equity of SA banks and the prime overdraft rate (ODR)



Sources: McGregor BFA, SARB

2.5 RETURNS OF BANKS AND NON-BANKS

A comparison of the profitability of the banking sector with that of other sectors of the South African economy provides some insight into the implications of market structure and levels of competitiveness for industry returns. To the extent that profitability in the banking sector is consistently higher than that of other competitive sectors, this may be indicative of inadequate levels of competition amongst banks, or amongst suppliers of specific financial products. In order to undertake such a comparison across industries, the financial statements, and ratios derived from them, had to be standardised – so that similar measures and definitions could be applied to the data.

The analysis reflected in Graph 2.5.1 indicates the **average returns on equity** of listed South African banks were lower than that of the **retail sector** from 1993 to 1999. However, in recent years average returns in the retail sector dropped sharply - to below those earned in the banking sector. The fact that the number of listed retail firms is greater than that of the banking sector may be construed as implying that levels of competition amongst retailers sector should be higher, but this would be a simplification. Since retail activity covers a diverse range of products it is possible that trade in some product types is characterised by relatively low levels of competition.

By contrast, the data in Graph 2.5.2 show that average returns on equity in the **telecommunications sector** – which is characterised by a small number of listed firms and a high degree of concentration – were consistently lower than those in the banking sector between 1993 and 1999, and only exceeded them (albeit by a large and increasing margin) in 2000 and 2001.

Table 2.5.1 shows that while the average return on equity in the banking sector over the period 1993 to 2001 was – at 17,4% - higher than sectors such as life assurance, financial services, food, clothing, furniture and transport, it was lower than that achieved by the retail, diversified industrial, electronics and electrical, information technology and telecommunications sectors. However, it is fair to note that the market capitalisation of the diversified industrial, information technology, electronics and electronic sectors each represent a small share of the market capitalisation of the JSE Securities Exchange, whereas the banks represent 15% of the total market capitalisation.

Generally, those sectors with higher returns are either relatively concentrated (as in the telecommunications sector), or highly niched (as in diversified industrial and information technology). They are also sectors in which product life cycles are generally short and levels of technological innovation are high. The **variability in average returns** – which ranges from 18,7% to 88,2% over the study period - reflects this risk. **The sectors in which average returns were lower than in banking have experienced heightened international competition due to reduced levels of tariff protection** in tradable goods sectors such as food, clothing and furniture, and the entry of new firms into established markets that was – in part – facilitated by technological progress.

Apart from the absolute level of returns on equity earned in different sectors, it is noteworthy that the **variability in returns in the banking sector is far lower than in any of the other sectors analysed**. In relative terms profitability in the banking sector exhibits limited variation over the course of the business cycle - with the difference between the highest and lowest returns on equity only 3,9 percentage points. By contrast, variation in returns in other sectors ranges from 10,9 percentage points in a "non-cyclical" sector such as food, to 88,2 percentage points in the diversified industrial sector.

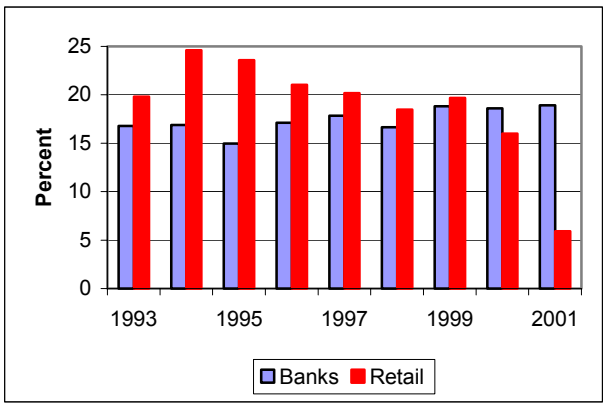
By contrast, the average return on equity of the top 100 banks ranked by *The Banker*, showed a variation of 8,6 percentage points over the study period. This suggests that, in relative terms, **the South African banking sector has a greater ability to secure its margins over the course of the business cycle** than both other local sectors, and a benchmark of international banks.

Another relevant form of profitability measurement (Wallis, 1997) is **return on assets (ROA)**. However, while this measure may be valuable in comparing intra-sector returns, it probably has limited value in assessing returns across sectors. Returns on assets in the banking sector are generally quite low because loans and advances make up a high proportion of banking assets. In South Africa around 75% of banks assets are loans and advances. The ability of banks to extend loans on the basis of fractional reserves that then form part of their assets sets the banking sector apart from other sectors. As a result, the asset base of the banking sector is inflated.

A comparison of the average ROA in the banking sector with that of the retail sector indicates a sizable gap. Between 1993 and 2001 the average ROA of the retail sector was 13,7%, compared with 1,4% in the banking sector. However, returns in the retail sector have been declining steadily, whereas those in the banking sector have risen over much of the study period. **Even on an inflation-adjusted basis, the average ROA over the 1993 – 2001 period of the South African banking sector is almost double that of the top 100 international banks listed in *The Banker*** (see Graph 2.4.3).

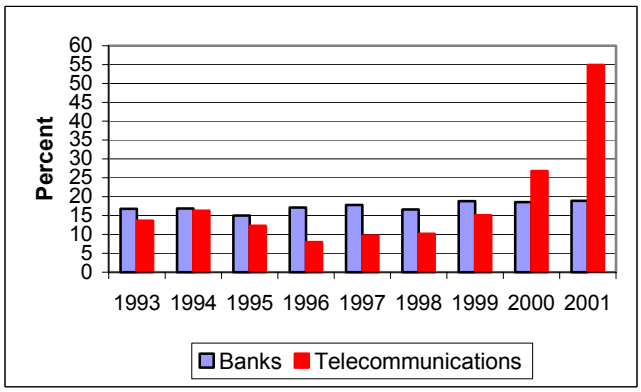
The return on assets in the telecommunications sector averaged 13,1% over the study period. Graph 2.5.4 shows that the return has risen steadily since 1997, after dropping sharply in the preceding two years. By contrast, the relatively stability of returns in the banking sector is apparent, notwithstanding the entry and exit of new players over this period.

Graph 2.5.1 Comparative returns on equity of SA banks and the retail sector



Source: McGregor BFA

Graph 2.5.2 Comparative returns on equity of SA banks and the telecommunications sector



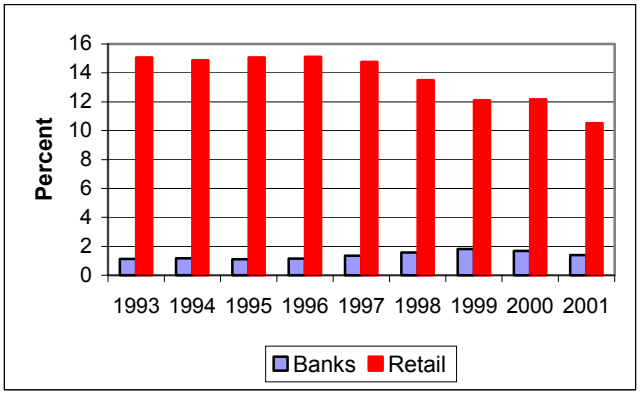
Source: McGregor BFA

Table 2.5.1 Comparative sectoral after tax returns on equity 1993 – 2001

Sector	Highest ROE	Lowest ROE	Average ROE	Variation in ROE
Banking	**18,9%**	**15,0%**	**17,4%**	**3,9%**
Life Assurance	17,8%	4,5%	9,6%	13,3%
Financial Services	16,3%	1,6%	10,6%	14,7%
Food	21,9%	11,0%	15,2%	10,9%
Clothing	16,6%	-6,6%	6,3%	23,2%
Furniture	23,4%	-20,8%	10,8%	44,2%
Retail	24,6%	5,9%	18,8%	18,7%
Diversified Industrial	100,2%	12,0%	49,5%	88,2%
Electronics & Electrical	31,6%	13,2%	20,3%	18,4%
Information Technology	85,0%	18,2%	36,4%	66,8%
Telecommunications	54,9%	8,0%	18,5%	46,9%
Transport	21,0%	9,2%	12,8%	11,8%

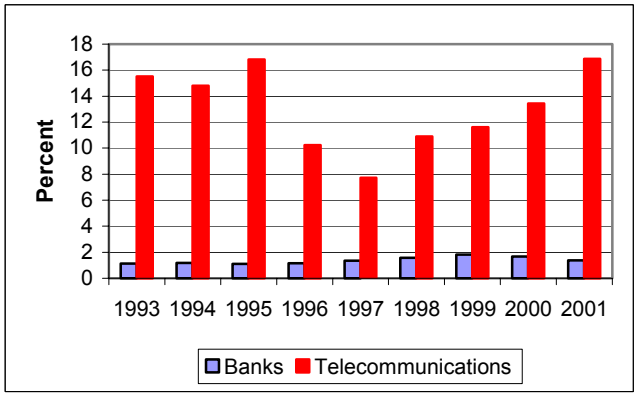
Source: McGregor BFA

Graph 2.5.3 Comparative return on assets of SA banks and the retail sector



Source: McGregor BFA

Graph 2.5.4 Comparative return on assets of SA banks and the telecommunications sector



Source: McGregor BFA

Chapter 3

Economic concentration

This chapter consists of the following sections:

1. Market share and economic concentration.
2. The Herfindal-Hirschman Index (HHI).
3. Concentration by market segment.
4. Efficiency and concentration.
5. Profitability and market competition.

The banking system is a vital service industry and where it is competitive and efficient, it is able to spur efficiency and innovation elsewhere in the economy. The converse is also true: there may be a transfer of welfare from individuals and non-bank businesses to the financial sector if the banking system is not competitive or efficient.

Measures of concentration may be used to assess competition in the sense of firms' domination in a market. Such measures may also be applied at product level, which often reveals a more nuanced picture. Crucial to this analysis is the ability to define market segments along product lines. Where there are no close substitutes for the products concerned, market share can be used as a measure of market power. The South African Competition Commission uses the SSNIP[1] test, which is based on the notion that if after a significant and non-transitory increase in price, there is no loss of market share, then the market segment must have been correctly defined. In the discussion here, both the concentration by firm and market segment is explored.

The conclusions of the analysis are as follows:

- The South African banking industry is relatively concentrated in terms of market share of assets, although the levels are not out of line with other emerging markets.
- The cost-to-income ratios of the banking sector have fallen as concentration has diminished and increased as concentration has intensified.
- The entry of foreign and niche players has resulted in increased contestability of the corporate and high value personal market segments.
- The demise of the small banks, together with consolidation in 2001 and 2002 has increased concentration levels back to their 1994 levels.
- The change in the competitive structure in 2002 allowed for an increase in interest margins.
- Fee income as a share of banks' income continues to increase. In the context of poor disclosure of fees this is also an indicator of market dominance.
- The absence of building societies or a robust credit union movement, together with patchy regional banking services mean there are few providers in certain market segments. For this reason, concentration in these market segments is even more marked than that at firm level.
- The banks perceive themselves to be involved in highly competitive market segments. Almost all market segments are rated as profitable by banks.

[1] SSNIP = Significant and Non-transitory Increase in Price

There are four major commercial banks in South Africa: ABSA, FirstRand, Nedcor and Stanbic, out of some 25 locally registered banks or deposit taking institutions[2]. While they have been the dominant players since the early 1990s, their market share has waned as new niche and foreign banks entered the market after 1995. After the demise of a number of smaller banks in 2001 and 2002, their shares once again increased. As can be seen in Graph 3.1.1, the four major banks made up 87 per cent of the market in 1994, but by early 2001 this had slipped to just over 75 per cent. The loss of market share by the top four players and the related increase in share won by smaller niche and foreign banks since 1994 meant that in early 2001, foreign and other banks made up close to 25% of the share of banking assets in South Africa.

This shift towards the niche players has occurred mainly in the corporate and high-net worth individual (private banking) market segments, with none of the foreign or niche banks targeting the mass retail market clientele. Until recently, foreign banks were restricted to the upper income end of the scale as they were prohibited from opening accounts with natural persons with deposits of less than R1 million.

This loss of market share in terms of assets was regained in 2002. By June 2003, the big four accounted for 83% of total deposits by the public. However, there is some renewed competition on the horizon, with Standard Chartered seeking entry via the Saambou Twenty20 internet banking venture (currently under curatorship) and Barclays considering rolling-out credit card services as a South African retail venture.

The dominance by fewer than six banks appears to be relatively common in a number of emerging and underdeveloped market economies, as shown in Figure 3.1.1. South Africa seems to be in a similar position to Brazil, the Czech Republic and Greece, and less concentrated than a number of Southern African countries and Mexico.

Simple comparisons like this are not enough, however. Evaluations of market share and concentration require that the market be defined so that the number of competitors within that market can be established. In a report on the proposed merger between Nedcor and Stanbic, the SA Competition Commission asserted that market concentration levels are a more important tool for analysis than market share, which in turn needs to take into account various sub-markets (2000, p. 11).

Once the basis of analysis shifts from firm to product there may be many non-bank competitors to the banks, such as retailers issuing their own credit cards. In the Wallis report into the Financial System of Australia (1998, p. 460), the performance of the major banks was compared to regional banks, building societies, foreign banks, credit unions, life companies, charge cards, retailers, and other suppliers. **In South Africa there are no longer any building societies and only a few regional banks (including MEEG, Ithala and Teba). The credit unions are marginal players and the foreign banks have remained exclusively in the corporate and investment bank niches.** Table 3.1.2 illustrates the range of services offered by banks and non-banks in Australia and South Africa. The absence of building societies, the difficulties of establishing small or regional banks in South Africa, and the low-levels of penetration of credit unions means that the South African financial environment is less extensively served than the Australian market.

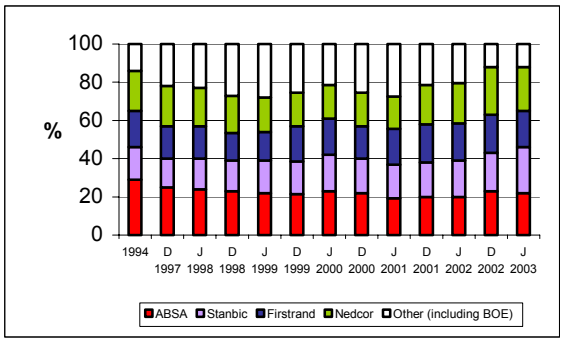
It is perhaps worth mentioning the regional/industry-based banks in South Africa. Eastern Cape-based MEEG Bank (formerly the Bank of Transkei) is partially owned by Absa (an effective 28.7%) and has 90,000 (personal and commercial) customers, with branches and ATMs in Gauteng and the Eastern Cape. Another unusual source of financial services is TEBA bank - a Chamber of Mines affiliate to TEBA, which was established over 100 years ago to recruit miners. TEBA Cash was used for the repatriation of funds to migrant workers and their families and was registered as TEBA Bank in 2000. It provides an example of an industry bank (with major shareholders from that sector) and effectively operates with very little competition given its base of operations on mining sites. See Chapter 7.

The data in Table 3.1.1 show the volume of credit extended to households by banks and non-bank institutions by product category. While the data for the non-banking industry are estimates, they come from industry experts and analysts and have been verified where possible by interview. While there may be some inaccuracies, they are probably correct by order of magnitude. **The data show that household credit is dominated by the banks, although almost 30% of credit card business in terms of store cards and the like are provided by non-banks.**

Based on these data, the shares of the big four, other banks and non-banks in the household mortgage market are shown and compared to similar data for Australia. The level of bank concentration in the mortgage markets is far higher in South Africa than in Australia, although in both cases the banks dominate the market (see Figure 3.1.2).

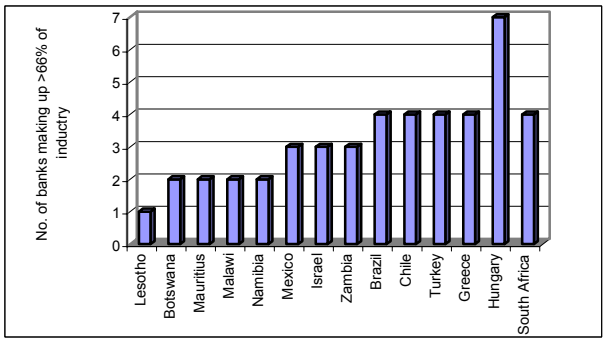
[2] As at December 2003.

Graph 3.1.1 Market share of Assets of Big Four



Source: Bank Supervision Department, Banking Council

Figure 3.1.1 Number of banks making up banking industry



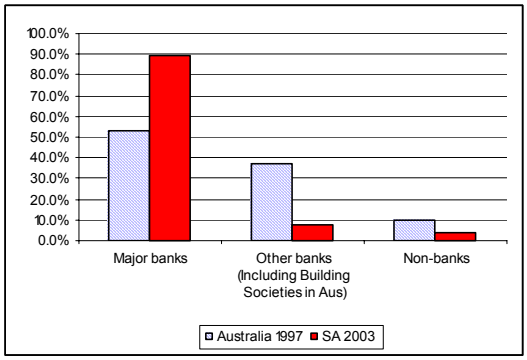
Source: Nedcor Annual Report, 2002, FEASibility, Report for SATRN, 2003

Table 3.1.1 Household credit by banks and non-banks

	Household credit provision			
	Billions of Rand			
As at September 2002	Bank Credit	Non-bank Credit	Total	Non-bank share
Credit cards	R 13.80	R 5.80	R 19.60	29.6%
Mortgages	R 191.80	R 7.00	R 198.80	3.5%
Personal loans (including micro-loans)	R 69.20	R 9.80	R 79.00	12.4%

Source: Bank Supervision Department, Industry estimates

Figure 3.1.2 Mortgage loan provision to households by banks and non-banks



Source: Wallis Report, Bank Supervision Department, industry estimates

Table 3.1.2: Matrix of Product provision by different providers

	AUSTRALIA					SOUTH AFRICA				
INSTITUTIONS	TRANSACTION ACCOUNTS	HOME LOANS	PERSONAL LOANS	SAVINGS / INVESTMENT PRODUCTS	CREDIT CARDS	TRANSACTION ACCOUNTS	HOME LOANS	PERSONAL LOANS	SAVINGS / INVESTMENT PRODUCTS	CREDIT CARDS
Major Banks	X	X	X	X	X	X	X	X	X	X
Building Societies	X	X	X	X	X					
Life Companies	X	X	X	X				X	X	
Regional Banks	X	X	X	X	X	X		X	X	
Credit Unions			X	X					X	
Retailers					X	X		X	X	X
Foreign Banks		X	X	X	X	X		X	X	X
Others	X	X	X	X	X			X		

Source: Wallis, 1997, SARB

3.2 THE HERFINDAL-HIRSCHMAN INDEX (HHI)

Several indices may be used to measure concentration in a banking system. The most widely used index is the Herfindahl-Hirschman Index (HHI). The HHI takes into account both the number and relative size of banks in the system. It is most commonly calculated by summing the squares of the market shares, so that if the industry consists of a monopolist then the HHI = $(100)^2$ = 10000, or if it is a contested market with 100 firms, each with a 1 per cent market share, then the HHI = $(1)^2$ x 100 = 100. The higher the value, the less competitive the market. Merger guidelines adopted by the US Federal Government in 1982 divided markets into three categories:

- HHI score <1000
  Unconcentrated
- HHI score between 1000 and 1800
  Moderately concentrated
- HHI score > 1800
  Concentrated

The South African Competition Commission applies Australian and Canadian benchmarks for concentration thresholds (as used by the Australian Competition and Consumer Commission, ACCC, and the Canadian Competition Bureau, respectively). Both institutions use the (largest) four firm concentration ratio (CR4) to assess whether or not mergers should be challenged, with thresholds of 75% or more in Australian instances and 65% or more for Canadian.

The South African Bank Supervision Department of the SARB publishes the HHI index for the registered banks, calculating the HHI in the conventional way, and then dividing by 10000. Concentration levels become a concern when the index reaches a level of 0,18. The data in Graph 3.2.1 show the HHI index as published by the SA Reserve Bank. The HHI declined steadily from 0,170 in 1995 to 0,136 in 1998, both as a consequence of greater foreign participation in the local banking industry and the entry of niche players. From 1998 to 2001 the HHI remained stable, before deteriorating to 0,175 in 2002. Between 2001 and 2002 the number of registered banks together with foreign branches and mutual banks fell from 58 to 45, making the HHI 0.147, but when the Nedbank-BOE merger is taken into account the HHI deteriorates to 0,175 (and pre-1995 levels). This represents an increase of 33,4% per cent in the HHI from 2001 to 2002. This level is only slightly below that associated with high levels of concentration. However, as has been discussed, it may well be that it is more appropriate to evaluate levels of concentration by sub-market rather than by firm. **When evaluated by product, higher levels of concentration are evident than when the firm analysis is applied (see section 3.3.)**

The variations in the concentration of the banking system are plotted with the reported cost-to-income ratios of the banking sector in Graph 3.2.2. **It is apparent that cost-to-income ratios have fallen (and hence efficiency has improved) as concentration levels have fallen.** This suggests that new entrants have had a positive impact on efficiency. (This will be discussed in Section 3.4.)

A rise in the concentration of the banking system, as seen in the South African market between 2001 and 2002, is associated in the literature with an increase in the market power of banks. Hence a higher concentration in the banking environment is associated with higher margins between lending and deposit rates and higher levels of profits earned by banks. Most data for European banking systems, for example, indicate a positive and significant relationship between concentration and financial margins (Bank Supervision Dept. Annual Report, 1998). (This association does not take into account a number of other factors that may lead to higher profitability, some of which were dealt with in Chapter 2).

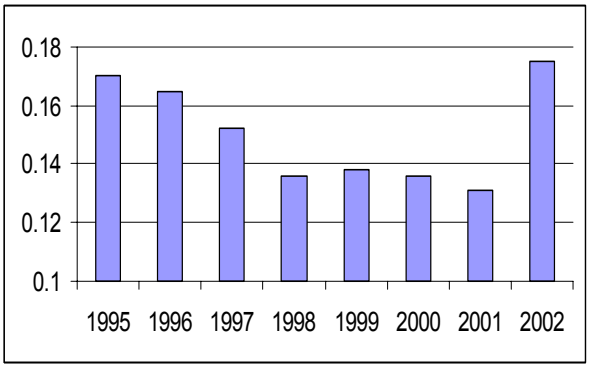
One argument suggests that banks will be more profitable because they are more efficient, and that because they are more efficient they will achieve a larger market share. This suggests that the relationship between market concentration and profitability is not uni-directional. Alternatively, regulation might restrict the entry of new banks to a market, enhancing the opportunity available to existing banks to take excessive profits. In general, **if a market is contestable, there will be less opportunity for banks to generate excessive profits or to have unduly wide margins** (Bank Supervision Dept., 2003).

The impact of the demise of the smaller banks in 2001 and 2002 had an immediate effect on the interest margin, so that the final quarter data for 2002 show an up-tick (Bank Supervision Dept., 2003). Table 3.2.1 shows the average margins on loans and advances values for 1999 and 2002, which do not yet reveal this increase.

However, the increase in interest margins is not the only indicator of market dominance. While the banks tend to compete on advertised interest rates, they are less inclined to advertise the fees attracted by these products. The share of interest income has been on a declining trend as share of non-interest income has grown over recent years. While this is an internationally documented trend, in South Africa where disclosure regarding fees is weak, fees can be a lucrative source of income. The data showing the decline of the share of interest income in banks returns is shown in Table 3.2.2 and the relative importance (between 60% and 70%) of fee income in non-interest income is shown in Table 3.2.3. For the industry, fee income makes up around 80% of non-interest income.

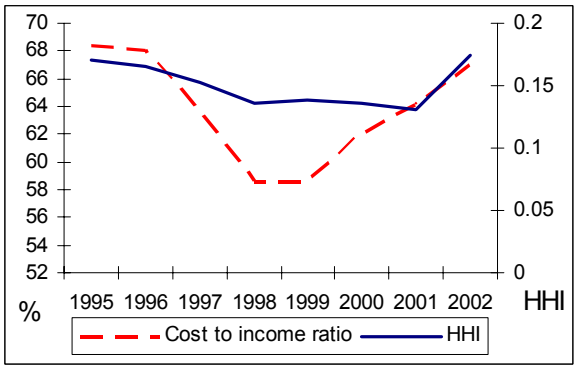
3.2 THE HERFINDAL-HIRSCHMAN INDEX (HHI)

Graph 3.2.1 The HHI for the South African banking sector



Source: Bank Supervision Department, Annual Report 2003

Graph 3.2.2 The HHI and cost-to-income ratio for the South African banking sector



Source: Bank Supervision Department

Table 3.2.1 Net interest margins on South African deposit accounts

	Net interest margin				
	ABSA	FirstRand	Nedcor	Standard	Average
1999	4%	5%	4%	4%	4%
2002	3%	4%	3%	3%	4%

Source: Audited results 2002

Table 3.2.2 Declining share of interest income for the banking industry

R '000	1996	1997	1998	1999	2000	2001	2002
Total income	R 20,962,561	R 25,336,132	R 31,593,672	R 36,170,623	R 39,879,536	R 56,160,000	R 59,284,960
Net Interest earnings	R 13,004,604	R 15,179,969	R 17,744,865	R 20,475,617	R 22,105,186	R 30,750,915	R 30,376,116
Interest income as a % of total income	**62%**	**60%**	**56%**	**57%**	**55%**	**55%**	**51%**
Non-interest income as a % of total income	**37%**	**40%**	**44%**	**43%**	**45%**	**45%**	**49%**

Source: Bank Supervision Department, Various

Table 3.2.3 Sources of bank income, 2002

	FNB		Nedcor		ABSA		Standard		Average
	R million	%	R million	%	R million	%	R million	%	%
Total non-interest income	8139		6929		9127		11435		
Of which Transactional income (Fee and Commission)	5132	63%	4655	67%	6139	67%	7094	62%	65%
Trading income	1772	22%	1199	17%	1682	18%	3244	28%	22%
Investment income	862	11%	490	7%	305	3%		0%	5%
Other	373	5%	585	8%	93	1%	1097	10%	6%

Source: Audited results 2002

3.3 CONCENTRATION BY MARKET SEGMENT

When analysing market concentration, regulators have to decide how to define the relevant market and hence which firms to view as competitors.

While proposing the use of the SSNIP test to define the relevant market segments, the Wallis report (1997, p. 431 ff) hastened to add that defining markets is not an exact science and is often clouded with controversy. The authors suggested that "substitutability, competition and market power are all matters of degree, requiring the exercise of some judgment in the delineation of relevant markets. Essentially that judgment must turn on what quantum of market power is worth worrying about."

These matters of judgement are also apparent in the South African definition. For example, the SA Competition Commission (SACC) criteria for evaluation of proposed mergers are[3]:

- **Relevant markets** (in terms of product offering, operations by geographical area, as well as competition) based on calculations of concentration ratios, evaluations of import competition and barriers to entry.
- **Competitive criteria for each market**, used to determine whether the merger would prevent or lessen competition, including the extent of foreign competition, barriers to entry, the impact of technology on the market and whether an effective competitor will be removed or not.
- An assessment of **claimed efficiencies**, technology gains or other pro-competitive gains arising from the merger.

Australian, Canadian and UK banking research identifies corporate banking, retail banking services for personal customers and retail banking services for small businesses as distinct market segments (SACC, 2000 p. 9). In addition, these may be further disaggregated into products or services such as current accounts, and mortgages. As far as is possible, the market will be disaggregated by segment and product here, as:

1. The distinction between banks and non-banks is increasingly blurred, as they are competing in similar sub-markets.
2. Competitive conditions and profitability vary considerably between sub-markets (SACC, 2000).
3. Banks behave differently in different sub-markets.
4. Banks are shifting to customer and product profitability models to allow them to set price more accurately (Wallis report, 1997 p. 141).

In the past regulators viewed commercial banks as distinct from other financial institutions. This is changing, however, since brokerage and insurance companies and even retailers offer products similar to those offered by commercial banks. When these other financial institutions are included concentration (as measured by the HHI) falls.

In South Africa, however, there are few non-bank providers in certain sub-markets. This means that in these markets, disaggregation reveals higher, not lower concentration. For example, as discussed in Figure 3.1.2, over 95% of mortgages are provided by banks in South Africa, with non-bank provision only at the margin. In the mortgage loan market the HHI index comes out at about 0.23, over the 0.18 threshold mentioned by the regulator. At sub-market or product level, the concentration is higher than at the firm level. Table 3.3.1 shows the market share over the past two financial years as calculated by ABSA.

While the Bank Supervision Department estimates the market share of the Big Four after the Nedcor-BOE merger to be 82 per cent, this appears to understate the market share in three of the product categories listed below: credit cards, mortgages and installment finance**.** In these markets, the share of bank credit by the big four is 95.4 %, 92.3% and 89.5%, respectively. While the market shares of the big four are lower for overdraft and other loans than the other product sub-markets, at 78.8%, it is still high by international standards. In the Cruickshank report, (2000, p. 19)[4] the market share of UK's big four in the current account sub-market was considered too high at 69%.

The data for each of the Big Four by product segment is shown in Figure 3.3.1 as at June 2003. These data clearly show that FNB has a scale monopoly in instalment sales, ABSA in mortgages and credit cards, Standard bank in credit cards and Nedbank in overdrafts and other loans.

Table 3.3.2 shows that in each market segment, the share of the Big Four has increased since 1999, with the most marked growth in mortgages and overdrafts. This suggests that the demise or incorporation of the smaller banks, including BOE; has exacerbated concentration in the retail segments.

[3] South African Competition Commission (2000)

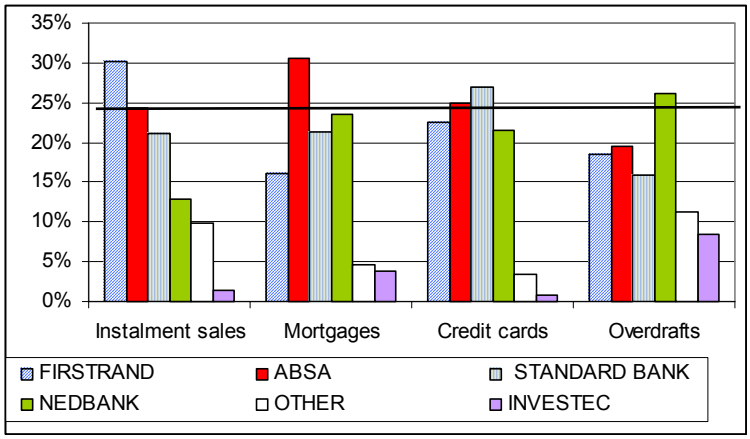
[4] There are no comparable data for overdrafts and other loans in the Cruickshank Report

Table 3.3.1 Market share in four product categories

Market share by Product Category (%)								
	Credit Card		Mortgage Loans		Instalment finance		Overdraft & other loans	
Reporting year	2001/02	2002/03	2001/02	2002/03	2001/02	2002/03	2001/02	2002/03
ABSA	23	25	31	32	25	25	20	21
SBIC	21	26	19	21	21	22	17	17
FirstRand	22	23	15	16	29	29	17	16
Nedcor/BOE	30	22	25	24	13	13	23	24
Other	5	5	10	8	12	11	23	21
TOTAL	100	100	100	100	100	100	100	100
TOP Four	95	95	90	92	88	90	77	79

Source: ABSA Annual report for the year ending March 2003

Figure 3.3.1 Market share by product segment (June 2003)



Source: Bank Supervision Department

Table 3.3.2 Market share of Big Four since 1999

	June 1999	June 2001	June 2003	% growth
Instalment debtors; suspensive sales and leases	84%	84%	89%	5%
Mortgage loans	73%	73%	92%	25%
Credit-cards debtors	94%	94%	96%	2%
Overdrafts and loans	73%	69%	80%	10%

Source: Bank Supervision Department, based on DI returns

It has been suggested that market structure stems inevitably from the economies of scale and scope associated with banking, and not from regulatory barriers to entry or a lack of effective competition scrutiny.

However, as the Cruickshank report (1998 page 20) points out, "a range of academic studies indicate that economies of scale in traditional banking are not that high. For example, a study into the globalisation of firms looked at a very wide range of research on scale economies within commercial banks. It concluded overall that the average cost curve has a relatively flat U-shape. In other words, medium-sized banks with assets in the range of $100 million to $10 billion were slightly more efficient than either large or small banks."

In the Wallis report, it was also found that there was no clear correlation between efficiency and size – regardless of whether operating expenses were expressed as a proportion of asset or income ratios.

While economies of scale may suggest the importance of size and market dominance, the notion of X-inefficiency suggests that comfortable incumbents may not produce in the most efficient method. If a few players dominate the market, they may be sheltered from competitive forces and may use rule-of-thumb rather than best-practice methods. Examination of the efficiency of the South African banking system since 1994, suggests that as new entrants made inroads into market share, cost efficiency improved. (This was discussed in Section 3.2, see Graph 3.2.2.)

In the banking industry efficiency is measured as a ratio between operating expenses and total income. In the Bank Supervision Department's Annual Report (2001), banks with assets above R5 billion and below R10 billion were seen as the most efficient, with a cost-to-income ratio of 45%, and the larger banks (with assets greater than R 100 billion) next best with an efficiency ratio of 46% (see Figure 3.4.1). Very small banks in particular were seen to have room to improve, compared to the international norm of 60%.

The data for 2002 represent a significant change (See Figure 3.4.2). The change in efficiencies of banks with assets less than R1 billion improves dramatically from 2001 to 2002, while the category of banks R50 billion – R100 billion disappears as they were merged with other banks.

While a cost-to-income ratio may provide a rule of thumb by which to judge efficiency, it does not allow for analysis of market dominance and the ability of a dominant bank to grow its income as expenses climb.

The Wallis report (1997, p. 606) distinguishes between allocative, technical and dynamic efficiency.

Allocative efficiency is the extent to which resources available to the finance sector are being allocated to the use with the highest expected value (including across time). This essentially amounts to a 'user pays' system where the fees and charges reflect the underlying costs of providing the service. This efficiency is low where mispricing and cross-subsidies are the order of the day. While South African banks are inclined to charge fees for each transaction (see Chapter 8), it is difficult to know whether or not these reflect cost.

Technical efficiency is the extent to which the output of the finance sector is being maximised for a given amount of productive inputs or the extent to which average production costs are minimised in the long run. Operating expenses may be used as a proxy for technical efficiency. Technical efficiency is generally what is meant when the term 'efficiency' is used. In Graph 3.4.1, the growth of the banks' declared operating expenses are plotted relative to their growth in income. Only in one year, 2001, do the operating expenses outgrow income.

The second possible measure of technical efficiency is productivity. The Wallis report suggested using the financial sector assets as a proxy for output in evaluating productivity in the banking sector as the relationship between outputs and inputs. In Graph 3.4.2, the productivity of the financial sector, of which the bank sector is by far the biggest part, has improved since 1994. This has not come without cost: while real earnings per employee have increased; employment has fallen.

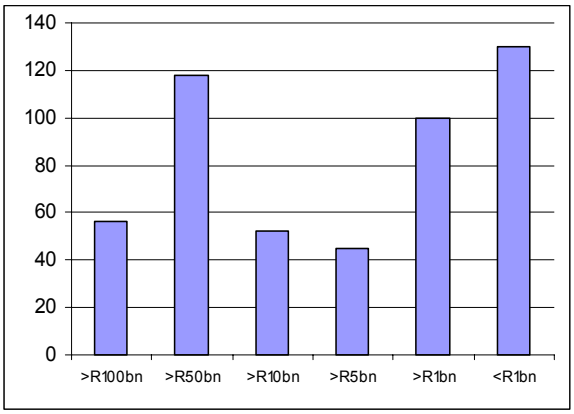
Dynamic efficiency is the extent to which the finance sector engages actively in product innovation and makes use of the most cost-effective technologies as they become commercially available. One possible measure of dynamic efficiency is expenditure on capital expenditure and development of innovations.

The list of innovations provided in Table 3.4.1 suggests that over the past two decades there have been significant innovations in the sector. It is probably fair to conclude these have been stimulated by competition at the high end of the market and advances in technology, rather than driven by demand in the lower end of the market.

In a contestable market, the benefits of efficiency gains are more likely to be shared with the consumer. In less contested markets the gains from efficiency improvement accrue to the shareholders.

Figure 3.4.1 Efficiency in the SA banking industry by asset size, 2001

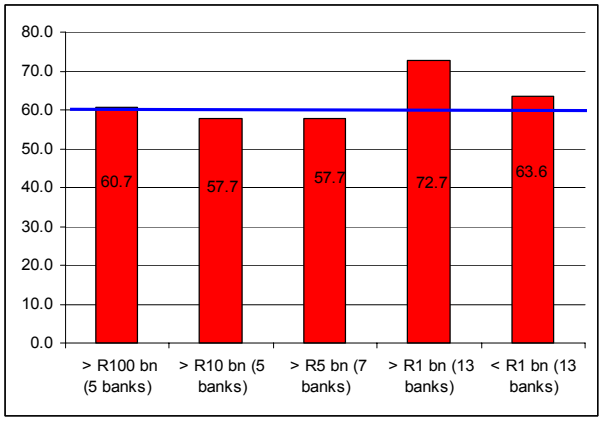
(Per cent)



Source: Bank Supervision Department, Annual Report 2001

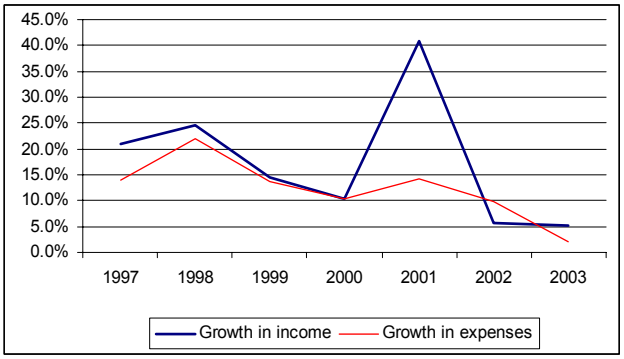
Figure 3.4.2 Efficiency in the SA banking industry by asset size, 2002

(Per cent)



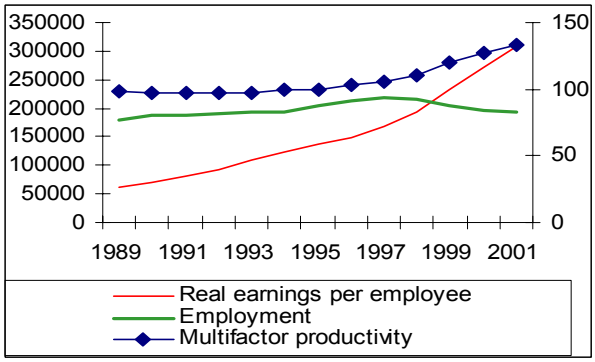
Source: Bank Supervision Department

Graph 3.4.1 Operating expenses and income growth



Source: Bank Supervision Dept

Graph 3.4.2 Total factor productivity of financial sector



Source: Productivity SA

Table 3.4.1 Product innovations over the past fifteen years

Prior to 1995	1995-2000	2000 onwards
Telephone banking	Real time electronic settlement	Mobile phone banking
Access mortgage bonds	Use of satellite communications for branch activities	Introduction of biometrics on cards for the payment of pensions
International ATM linkages	PC banking	SMS messaging service
	Automated credit scoring	GPRS communications technology for mini-ATMs to make them operational in remote areas
	Debit card transaction	Debit orders on saving accounts

Source: Harris, 2003. Hawkins, 2004.

3.5 PROFITABILITY AND COMPETITION

This section makes use of the responses recorded in the annual Price Waterhouse Coopers (PWC) survey: *Strategic and emerging issues in South African banking* (2003), based on interviews with 22 banks, to gain a sense of the profitability and competitiveness by market segment. The survey provides information on perceived competitiveness and realised profitability. In addition, it provides a sense of the number of banks active in each segment. For example, only those respondents active in a segment rated its profitability.

In Table 3.5.1, the banking industry's perceptions of competitiveness by market segment are shown. Respondents were asked to rank the competitiveness (none, light, moderate or intensive) of four segments: merchant (including investment) banking, corporate banking, retail banking and internet banking. The responses for moderate and intensive are shown here. Merchant banking, corporate banking and retail banking are perceived to be intensively competitive by the majority of respondents and it is in these three areas that banks have made significant[5] changes in response to competitive forces.

While 50% of the eight respondents thought internet banking was intensively competitive, this is almost double compared to the previous year, and may account for the high proportion of banks making fundamental[6] or strategic changes in this segment. The picture that emerges from Table 3.5.1 is that banks perceive themselves to be involved in highly competitive market segments and that generally they are responding to this competitive stimulus through operational or strategic change.

Respondents were also asked to rate the profitability (loss-making, marginally profitable, profitable, very profitable and extremely profitable) of the market segments in which they were active (Table 3.5.2). These data are for the most recent financial year and are instructive, as banks do not typically publish profitability by market segment. The responses of the banks are shown, together with the number of surveyed banks that are active in the segment.

The data show that all market segments are deemed profitable, with the majority of respondents indicating that each market segment is profitable. On average 27% of the respondents find all the segments marginally profitable, 33% find them profitable and 17% and 14% find them very and exceptionally profitable, respectively. **This means that 91% of the respondents rated the segments at least marginally (0-10%) profitable.**

Microlending is something of an outlier, with two of the four respondents indicating that it is loss making. This may have much to do with the timing of the survey, coming after the Unifer and Saambou debacles.

More banks are active in the merchant banking, private banking and treasury activities than other activities. This suggests greater contestability of these segments with greater ease of entry. By comparison, relatively few banks are involved in the retail segment. The lack of contestability (in terms of ease of entry) of this segment will be further explored in Chapter 8. It is notable that there are no branches of foreign banks operating in the retail banking, credit card, micro lending or insurance segments – all of which have a household rather than corporate flavour. Only one branch of a foreign bank is involved in internet banking.

In spite of the few players involved; (only 5 out of 22 (23%)) of the respondents in the survey are involved in retail banking), **banks involved in the retail segment generally see it as highly competitive. However, their responses indicate that they find their activities very or exceptionally profitable.**

This is brought out in Table 3.5.3, which compares perceptions of competitiveness and reported profitability. The perceptions of high levels of competitiveness but, at the same time, high profitability in the retail segment, may indicate that, while there may not be increased competition from new entrants, the pool of eligible consumers may be seen to be limited.

[5] Significant change implies operational and organisational change.
[6] Fundamental change implies a change in strategy and position.

3.5 PROFITABILITY AND COMPETITION

Table 3.5.1 Perceptions of competitiveness

	% who think it is competitive		% who have made a response to this demanding market		Number of banks responding
	Intensive	**Moderate**	**Significant change**	**Fundamental change**	
Corporate banking	84	16	45	11	18
Retail banking	83	17	33	17	6
Merchant banking	90	10	37	21	19
Internet banking	50	50	13	24	8

Source: PWC Strategic and Emerging Issues in South African Banking, 2003

Table 3.5.2 Ratings of profitability

In terms of return on equity	Profitability of segment in the last year (ranked by those active in the segment)					
	Loss-making	Marginally profitable (0-10%)	Profitable (10-20%)	Very profitable (20-30%)	Extremely profitable (30% +)	Number of banks active in segment
Retail banking	20%			60%	20%	5 (0)
Corporate banking	13%	6%	50%	25%	6%	16 (9)
Merchant banking	6%	17%	47%	24%	6%	17 (9)
Private banking	18%	18%	18%	18%	27%	11 (5)
Treasury	6%	25%	31%	19%	19%	16 (9)
Internet banking	14%	43%	43%			7 (1)
Credit cards	17%	17%	50%		17%	6 (0)
Asset management & nit trusts	14%	29%	29%	14%	14%	7(2)
Life insurance		50%	17%	33%		6 (0)
Micro-lending	50%	25%		25%		4 (0)
Stock brokerage		42%	42%	8%	8%	12 (4)

Source: PWC Strategic and Emerging Issues in South African Banking, 2003. Numbers in bracket indicate number of foreign branches included in each subtotal

Table 3.5.3 Competitiveness and profitability

	% of those active in the segment who rate it as intensively competitive	% of those active in the segment who found it very or exceptionally profitable	% of total number of respondents who are active in the segment
Retail banking	83%	80%	23%
Corporate banking	84%	31%	73%
Merchant banking	90%	29%	77%
Internet banking	50%	0%	32%

Source: PWC Strategic and Emerging Issues in South African Banking, 2003

Chapter 4

Simulation: Revenue, costs and competitiveness of banks

This chapter consists of the following sections:

1. The custodian process.
2. The transmission process.
3. The lending process.
4. The trading process.
5. The intermediation process.

The chapter sets out a model of costs and revenues for a variety of banking processes as they apply to registered South African banks that operate through a large number of branches and terminals for general public access. These costs and revenues illustrate the cost drivers that determine the ability of banks to service a particular profile customer and thereby highlight those factors that make that profile desirable or unattractive to banks. These factors will enhance competition in the desirable profiles while leaving the market under serviced in other areas.

Although the high-street banks have not provided data to verify this model it represents a considered understanding of the banking processes of a high-street bank. New entrants, such as cellular operators or retailers, may face different cost and revenue structures.[1]

The financial models developed for this chapter are based upon the assumptions of few, significant variables, (e.g. account opening costs, maintenance costs, loan origination cost and trading costs *et al*.) These variables are shown in the tables associated with each banking process. Assumptions of the proportion of fixed and variable costs, as well as the relationship between costs and revenues for varying account balances and transaction volumes, provides the analytical basis.

The preliminary conclusions of the analysis are as follows:

- The majority of savings accounts offered by high-street banks have transmission facilities. High interest margins on these accounts do not always compensate banks for the costs of operating them.
- The current institutional infrastructure required for transaction and payment functions mean that high volumes are needed to achieve economies of scale.
- Lending accounts are characterised by high costs for low balance loans and low cost for high balance loans. While the exemption of loans less than R10 000 from the Usury interest cap has encouraged banks to become micro-lenders, mortgage loans show sensitivity to loan size because the relatively high costs of loan origination must be recouped.
- In the trading functions it is important to achieve critical mass in trading values and volumes because of large sunk costs in infrastructure. Compliance costs in relation to money laundering and exchange control regulations contribute to these costs.
- Increased competition in trading is likely to emerge as communications technology, such as cellphone and Internet connectivity improves.
- Their mix of business influences the cost-to-revenue ratio of South African banks. With cash being the predominant form of payment, and the relatively high cost-to-revenue ratio for cash processing, it is not surprising that South African banks have higher cost ratios when compared to banks in more developed parts of the world.

[1] Chapter 5 provides analysis of potential competitors.

The custodian process of banks is characterised by the safekeeping of funds deposited by the general public. Banks provide custodian functions mainly in the form of savings, notice deposits and fixed deposit accounts (see Figure 4.1.1). Demand deposits included in the custodian function will also comprise credit balances maintained in cheque accounts.

Custodian Model

Costs: Banks incur, on average, total operating costs of some R1 600 per account per annum (see Figure 4.1.2). Much of this cost structure relates to transaction and infrastructure costs, but also includes account opening and closing costs. According to estimates by the Task Group, the custodian function incurs the following basic costs (see Table 4.1.1):

- *Account opening costs*: R100
- *Account maintenance costs*: R10 p.a.
- *Transaction processing costs*: R3
- *Account closing costs*: R50

Crucial factors in a successful custodian function are*:*

- **The ability of the customer to save**: the greater the size of the deposit the more competitive the yield on such deposits. Deposits of less than R 300 imply a loss to the banks (unless specific bank charges compensate). This is illustrated in Figure 4.1.6 that shows a marked reduction in the ratio of operating costs to operating revenue as balances increase.
- **The duration of a savings deposit**: the longer an account remains open, the greater the chance that the sunk costs can be recovered in the margin earned by banks. Figure 4.1.5 shows that the longer an account remains open, the lower will be the annual operating cost of the account.
- **Physical access to a repository:** travelling costs (time and transport expenses) are an important opportunity costs to the depositor.
- **The efficiency of the facility**: e.g. money stored in an account at a bank branch has a different efficiency profile from that stored in a smart card. In fact, the lower-income groups can only be profitably served by electronic means. In contrast, high net worth clients can demand personalised banking services.
- **The unbundling of services offered by banks:** Interest rates offered by banks on savings accounts are significantly lower than the rates required to break-even on a savings account (see Figure 4.1.5). This is often because other services and other accounts may be being subsidised by higher balance accounts.

As a result of efficiency gains in information technology and processing costs, the costs of operating a savings account has declined steadily, relative to the old book-based savings accounts. Technological advances have brought about a reduction of about 10 per cent in unit costs per bank account over the past 5 years. Further reductions can be expected as further automation and efficiencies are applied. However, the costs of the custodian function are also strongly influenced by economies of scale (see Figure 4.1.3).

In most instances, low interest rates paid on savings accounts result in high margins for banks. However, these margins do not compensate banks for the costs of operating the accounts, particularly where low balances are maintained in the accounts. In terms of the assumptions made, savings accounts with balances below R300 are nearly always unprofitable for banks. Most retail deposits have balances of less than R500, which implies that virtually no interest can be paid on such accounts (see Figure 4.1.4 and 4.1.5).

The longer the accounts remains open, the more opportunity there will be to recover the account opening and closing costs. There exists a direct relationship between the interest margins earned, the balances maintained and the period of operation of the account (see Figure 4.1.6).

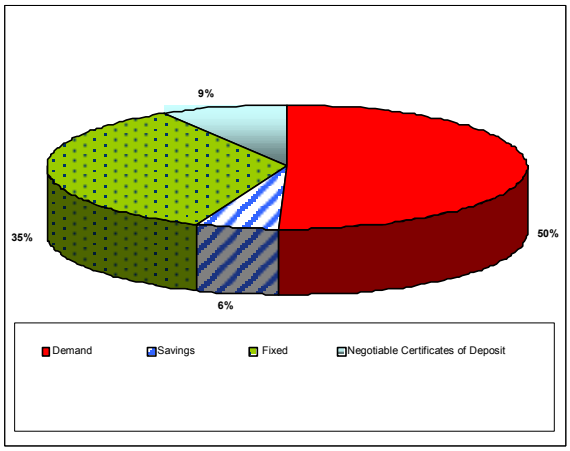
There is evidence of bundled pricing and cross-subsidisation in accounts classified as savings accounts where interest margins earned by banks on high balance accounts will support the operating costs of low balance accounts (see Figures 4.1.5 and 4.1.3).

Table 4.1.1: Breakeven analysis of retail 5-year deposit

Years	Investable Funds	Interest Earned	Interest Paid	Net interest Income	Opening Cost	Closing Cost	Process Cost	Repay Cost	Maint. Cost	Total net return
	10,000	10.00%	9.25%		100	50	3	3	10	
1	9,887	989	925	64	100		3		10	-49
2	9,838	984	925	59					10	49
3	9.887	989	925	64					10	54
4	9,941	994	925	69					10	59
5	10,000	1,000	925	75		50		3	10	12

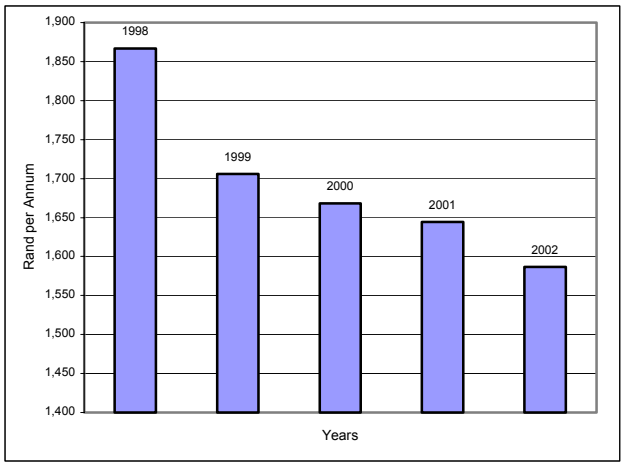
Source: Illustrative values

Figure 4.1.1 Types of custodian function accounts offered by banks



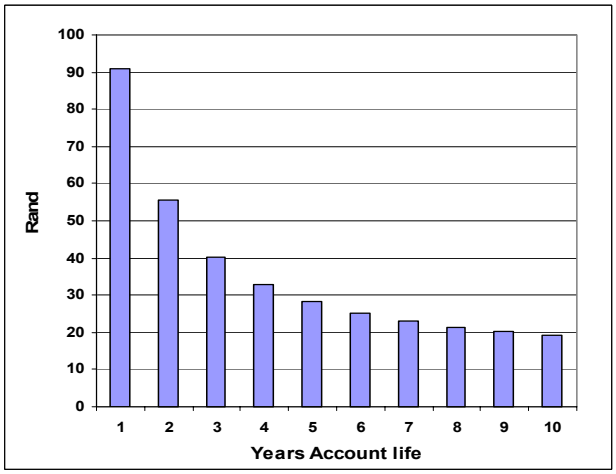
Source: SARB

Figure 4.1.2 Operating costs per bank account



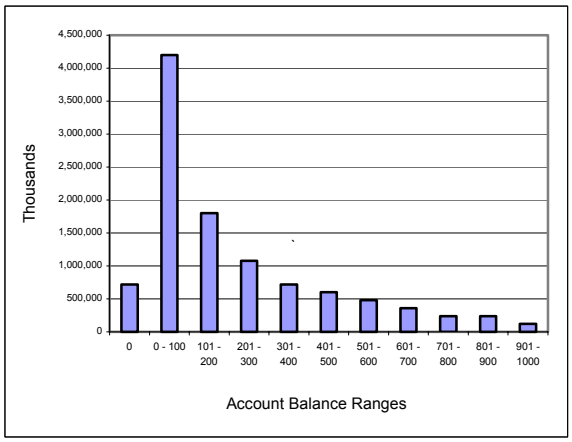
Source: SARB & Illustrative values

Figure 4.1.3 Opening, operating and closing costs to be recovered



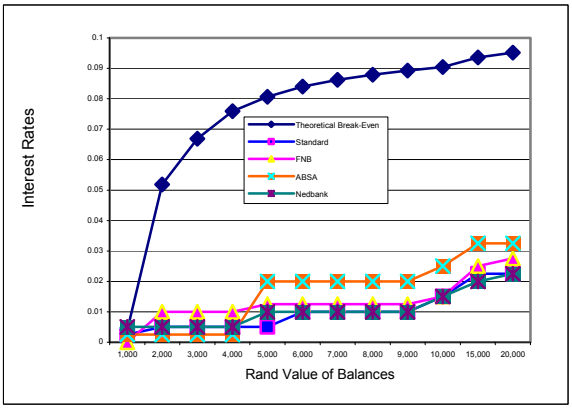
Source: Illustrative values

Figure 4.1.4 Number of savings/transmission accounts in each balance band



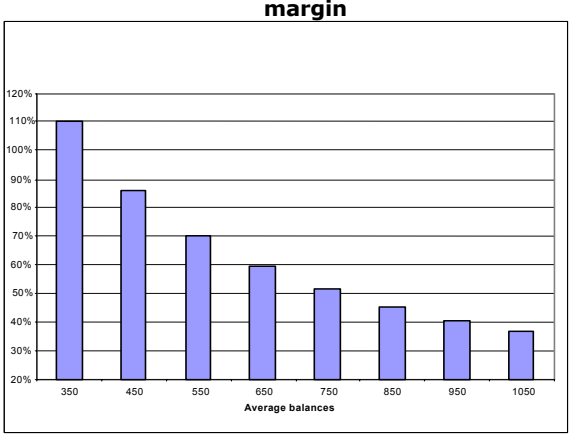
Source: Illustrative values

Figure 4.1.5 Break-even interest rates on savings accounts and bank offered rates



Source: Illustrative values

Figure 4.1.6 Percentage operating cost to operating revenue, for balances maintained at 7% interest margin



Source: Illustrative values

Cash remains the predominant means of payment in South Africa, with 90% of the volume of payments being effected in this manner (see Figure 4.2.1). However, 93% of the values of payments are affected by electronic payments (see Figure 4.2.2). Other means of payment include Debit Orders, Card Payments and Cheque Payments. These categories make up about 7% of the volume of transactions and about 4% of the value of transactions. These ratios clearly illustrate the continuing importance of cash handling in South Africa. In many cases, accounts are maintained to provide a wage payment facility and moneys are often drawn in cash soon after deposit. More cost effective cash handling and dispensing will facilitate competition in the transmission process.

It is expected, however, that electronic payment processes will ultimately make inroads into cash usage for payments.

Transmission Model

Costs: There are a variety of mechanisms by which funds can be transmitted. The most basic, and costly, is the physical transportation and delivery of cash. The most efficient, and cheapest, is the electronic transfer of funds from one account to another. The costs of setting up an infrastructure will depend upon the capacity and capital intensiveness of the delivery mechanism. Based on the assumptions as set out in Table 4.2.1, banks will tend to utilise their economies of scale. In this table, the fixed cost in transmission is higher than the variable cost where low volumes are processed.

Critical factors in a successful transmission function are*:*

- The development and maintenance of a secure physical storage and delivery facility. This requires high initial cost in controls and infrastructure.
- The development and maintenance of high speed, high volume and high capacity cheque processing facilities.
- The development and maintenance of high volume, high capacity facilities for the transmission of funds electronically.
- The development of connectivity to transfer funds from one system within the bank to another, and to other banks.
- The development and maintenance of a secure cash handling, transportation and storage facility.

Funds transmission is an evolutionary process. While here remains a demand for the most basic form of transmission, demand for electronic delivery is growing rapidly.

Where electronic transmission processes are used, the general rule is that there are high fixed costs, in the form of infrastructure, and relatively low variable costs. This cost structure gives rise to Figure 4.2.3, where total costs per unit will decrease relatively rapidly as volumes increase. The greater the fixed portion of the cost structure, the greater will be the economies of scale that can be extracted. On the basis of the assumptions in Table 4.2.1, Figure 4.2.3 shows that electronic transaction volumes below 20 million per annum will not be profitably processed.

Profitability of the transmission processes, as measured by the ratio of cost to income, is heavily dependent upon achieving sufficient volumes to recover fixed costs and variable costs per transaction type (see Figure 4.2.4). Furthermore, the mix of transmission processes used will determine the cost efficiency of a bank. The conventional wisdom of judging the efficiency of banking by the cost-to-revenue ratio is challenged by this analysis. Figure 4.2.4 demonstrates that the changes in the mix of volumes transacted through the different transmission methods will alter this ratio. In the model used, cheque processing will only begin to break-even with volumes of 30 million or more per annum. By contrast, debit orders and electronic transactions will break-even at about half these volumes. The main reason is that cheque processing has a higher fixed-cost component and variable-cost component than either debit orders or electronic processing (See table 4.2.1.) The relatively high proportion of fixed costs for electronic transactions compared to variable costs illustrated in Figure 4.2.5 demonstrates that economies of scale can be extracted more easily from other methods than through cheque processing.

As technology develops in transmission processes, various economies of scale can be expected to be available. This factor will also change efficiency ratios. Figure 4.2.6 illustrates how, with increasing volumes of debit orders being passed through high capacity infrastructure, revenue will first recover variable costs, then fixed costs before contributing to profits. With unit prices of R5 per transaction, it is only after 20 million transactions that the unit cost of processing will fall below the R5 mark.

With cash transmissions making up such a large proportion of the number of payments in South Africa, it is not surprising that retail stores are becoming increasingly active in cash dispensing and receiving cash payments on behalf of others.

As the transmission process is essentially the act of passing messages between senders and receivers, phone operators are well placed to enter this market, within current and future regulatory constraints.

Table 4.2.1 Estimated fixed and variable costs for transmission processes

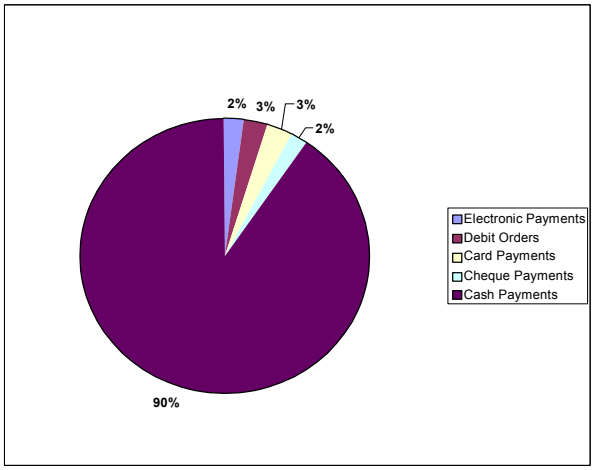
Volume	Transactions per annum	50,000,000
	Average value per transaction	R 500

Assumptions	Price per transaction Rand	Costs per transaction					
		Rand	Fixed	Rand	Variable	Rand	Total
Cash handling costs	4.25	0.75	30%	1.75	70%	2.50	100%
Cheque processing	7.50	2.50	50%	2.50	50%	5.00	100%
Debit orders	5.00	1.20	60%	0.80	40%	2.00	100%
Electronic transmission	2.50	0.70	70%	0.30	30%	1.00	100%

	Fixed costs	Variable costs	Total cost	Total revenue
Cash handling	37,500,000	87,500,000	125,000,000	212,500,000
Cheque processing	125,000,000	125,000,000	250,000,000	375,000,000
Debit orders	60,000,000	40,000,000	100,000,000	250,000,000
Electronic transmission	35,000,000	15,000,000	50,000,000	125,000,000
Total	257,500,000	267,500,000	525,000,000	962,500,000

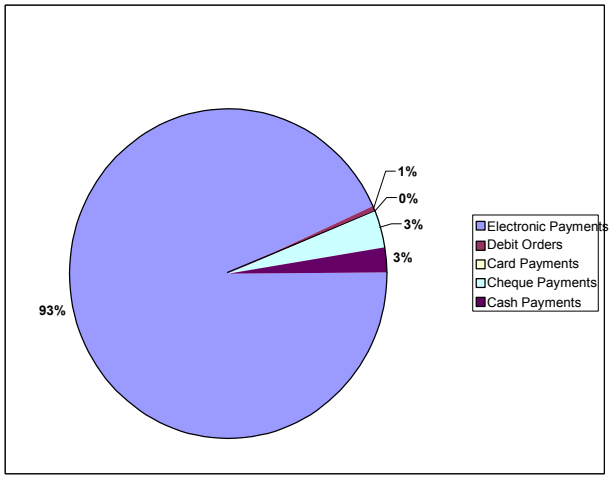
Source: Illustrative values

Figure 4.2.1 Payment Volume Proportions



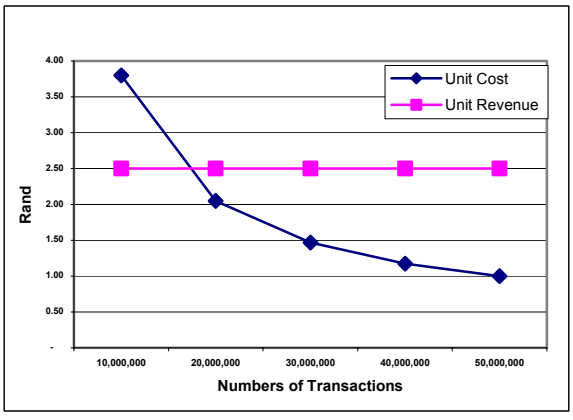
Source: Illustrative values

Figure 4.2.2 Payment Value Proportions



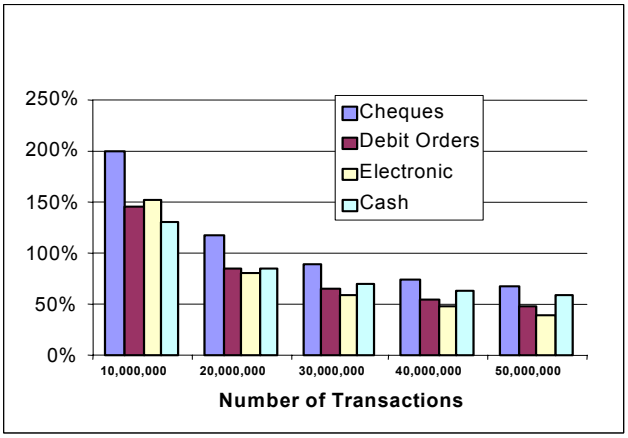
Source: Illustrative values

Figure 4.2.3 Break even chart – electronic transactions



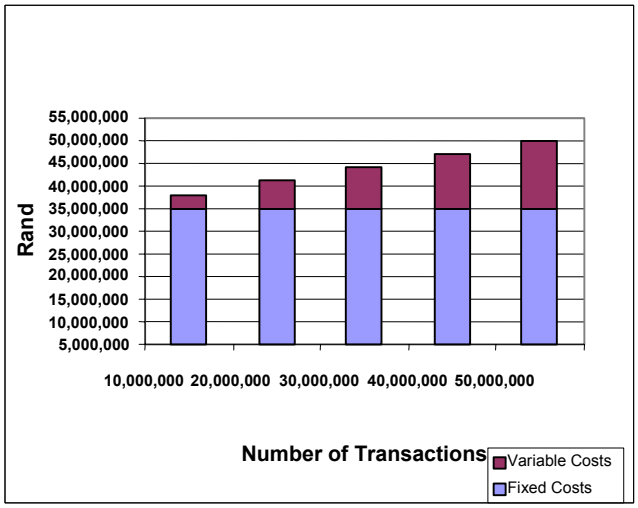
Source: Illustrative values

Figure 4.2.4 Cost-to-revenue ratios of transmission processes



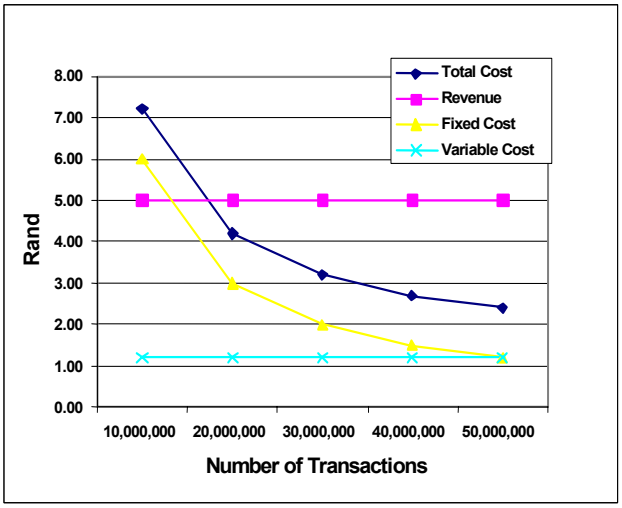
Source: Illustrative values

Figure 4.2.5 Cost structure – electronic transactions



Source: Illustrative values

Figure 4.2.6 Cost structure of debit orders



Source: Illustrative values

Bank lending can be secured or unsecured and for periods that can vary considerably. The types of lending undertaken by banks are usually through the medium of overdrafts, instalment credit, mortgage loans and credit cards (see Figure 4.3.1).

Lending Model

Costs: The main cost elements comprising the lending process are: loan origination, loan maintenance, and loan repayment, which includes the risk of non-payment.

In order to quantify the interrelationships between these cost variables, the Task Group estimated costs as follows:

- Loan origination costs – In the retail market, greater reliance is being placed on behavioural scoring to determine credit standing of existing customers. This process reduces assessment costs. *An estimate of R400 per loan is made for loan origination costs.*
- *Account maintenance costs are estimated at R360 per account per annum.*
- *Account closing costs are estimated at R100 per account.*

These costs exclude the cost of bad debts, which are separately estimated in Table 4.3.1. The data in the table show why the high-street banks could grant small loans under the exemption to the Usury Act. The total cost of credit (including interest rate and other fees) of micro-loans granted is typically in the region of 64-102% p.a. (MFRC, 2003). Loan costs in the wholesale market are normally specific to the loan terms and conditions of each loan.

Crucial factors in a successful lending function are*:*

- **The availability of a track record with the bank**: Credit scoring is generally done on an existing account. Assessments can also be based on external factors such as credit bureau ratings and employment records.
- **The security available for the loan:** Direct factors such as mortgages over property, title to vehicles or equipment under instalment sales and acceptable surety ships for personal loans.
- **The ability of banks to price loans to recover risk and operating costs:** Where banks are not exempt from the restrictions of the Usury Act, loans of less than R10 000 for periods of less than three years will be unattractive to banks (see Figure 4.3.2). This is because loan costs will exceed about 25% per annum of the loan amount, and loan revenues will not be much greater that 25% per annum. The longer the loan duration, the lower will be the amortisation of loan origination and recovery cost as a percentage of the loan amount.
- **The avoidance of granting too small mortgage loans:** Current estimates of loan origination, maintenance and recovery costs make loan values below about R30 000 unattractive to banks (see Figure 4.3.3). This is because mortgage costs on loan balances between R10 000 and R50 000 would amount to an annual cost of between 12% and 16% which reduces margins earned by banks where the funding cost is about 12% per annum.
- **The avoidance of granting cheque accounts to low-income earners:** Operating costs and fees charged for both debit and credit balances have the effect that LSM 4 income earners will pay, on average, about 4% of their gross income on bank fees (see Figure 4.3.6). Banks and their low-income customers would be better served in using lower costing and less functional products. This will assist in better affordability for the customer and better profitability for the banks.

It is likely that the same factors of improved technology and processing, as mentioned in the custodian function will reduce costs, which may provide for greater access to loan products.

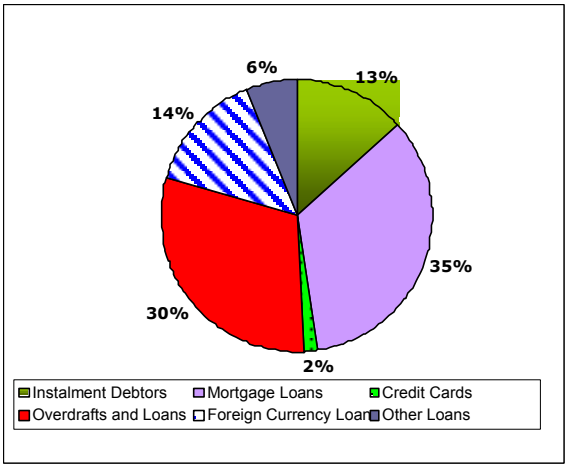
Conventional loan origination costs, particularly in the area of low cost housing, will need to be redesigned, possibly by some form of pooling mechanism that will reduce costs.

Table 4.3.1 Estimated costs and revenues for personal lending accounts

Assumptions						
Loan origination cost	R 400					
Loan maintenance cost	R 360					
Loan closing cost	R 100					
	Average balance	*Average balances in rand*				
	years	*1,000*	*5,000*	*10,000*	*15,000*	*20,000*
Failure rate		18%	14%	9%	5%	3%
Costs 1 year	1	860	860	860	860	860
Costs 2 years	2	610	610	610	610	610
Costs 3 years	3	527	527	527	527	527
Operational costs	1	86%	17%	9%	6%	4%
	2	61%	12%	6%	4%	3%
	3	53%	11%	5%	4%	3%
Risk costs	1 to 3	18%	14%	9%	5%	3%
Funding costs	1 to 3	10%	10%	10%	10%	10%
Total costs	1	114%	41%	28%	21%	17%
	2	89%	36%	25%	19%	16%
	3	81%	35%	24%	19%	16%
Usury Act ceiling		24%	24%	24%	21%	21%

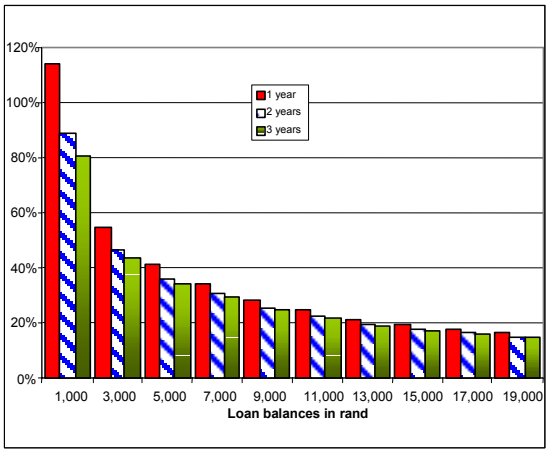
Source: Illustrative values

Figure 4.3.1 Types of lending function accounts offered by banks



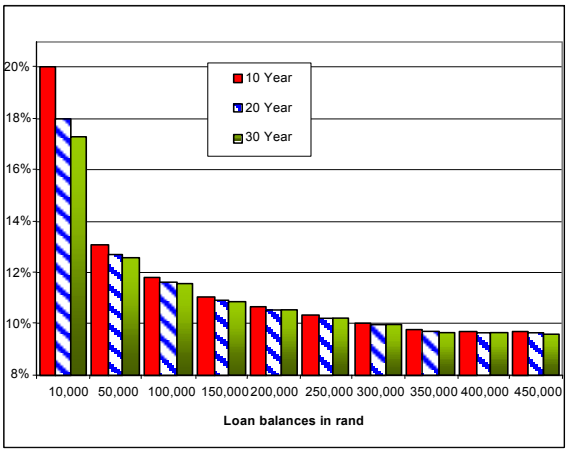
Source: SARB

Figure 4.3.2 Total costs as % of loan amounts



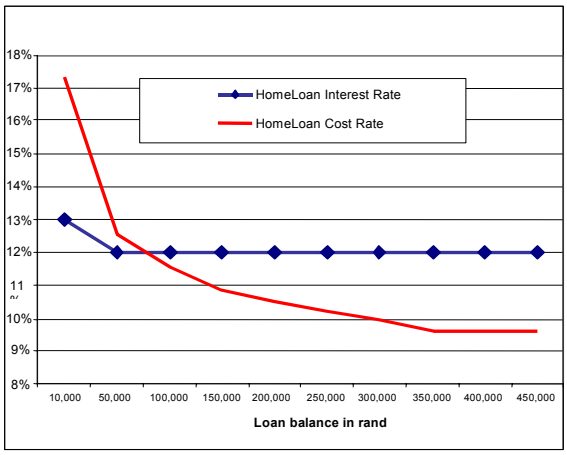
Source: Illustrative values

Figure 4.3.3 Mortgage costs as a % of balances



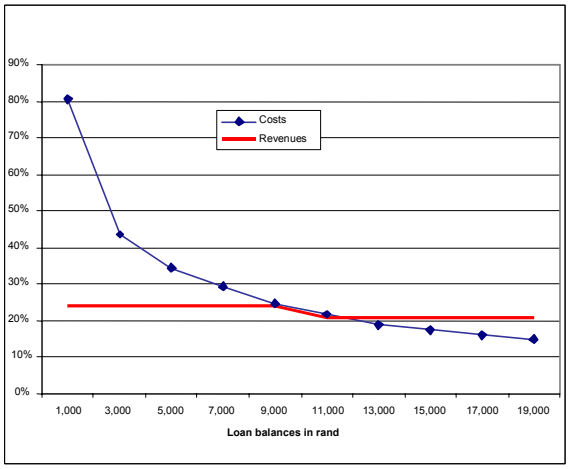
Source: Illustrative values

Figure 4.3.4 Cost and revenue per balance for 20 year mortgage loans



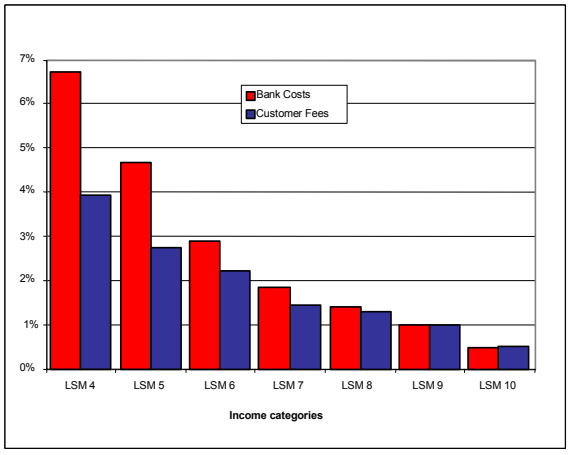
Source: Illustrative values

Figure 4.3.5 Costs and revenues per balance for 3 year loans



Source: Illustrative values

Figure 4.3.6 Annual fees and costs as % of income for accounts



Source: Illustrative values

The trading process of banks largely involves the buying and selling of currencies (about 75% of the total trading by banks), fixed-interest securities (15%), and equities (10%). By far the vast majority of trading takes place within the wholesale market, but retail customers do participate, particularly in the purchase and sale of foreign currencies, in the form of traveller's cheques and foreign notes, as well as the buying and selling of equities (i.e. mostly unit trusts).

The Trading Model

Costs: The costs of executing a trade, settling a trade and the sunk costs associated with the infrastructure to ensure connectivity are reflected in Table 4.4.1. This table illustrates that, with sunk costs of R20 million per annum, the number of deals and the size of each deal heavily influence the cost structure per transaction. As pricing varies between the retail and wholesale markets, costs have been apportioned to demonstrate the profit sensitivity in both markets to volumes of transactions. While these costs are rough estimates, they indicate high dependence on infrastructure expenditure.

Crucial factors in a successful trading function are:

- **Trading requires high volume business:** In most banks, trading infrastructures are fixed, with a low proportion of their cost bases variable. High volumes are therefore necessary to "feed the machine".
- **Any successful player in this market will need substantial capital outlays:** Particularly in the foreign exchange market, players will need to invest in connectivity to automated exchanges, dealing systems and settlement systems.
- **The trading function will need to leverage its business:** Leveraging can be facilitated where an existing transactional relationship is maintained with the customer. This enables the trader to effect settlement to an existing account or to provide safe custody of the proceeds of the trade.
- **Regulatory compliance and approvals knowledge:** It is essential in foreign exchange trading to have the appropriate expertise to operate under the Exchange Control Regulations.
- **Improved technology needs to reduce connectivity costs:** Already, customers are able to interact with traders via the Internet and through cell phone communications. The wider connectivity will reduce fixed costs and reduce barriers to entry.
- **Risk based pricing is essential:** Most prices are based on a minimum charge plus an ad-valorum fee for each trade. Competitive conditions in the wholesale market are more likely to move traders into unbundling of fees into risk related work fees and risk related settlement fees.

On the basis of the cost assumptions in Table 4.4.1, retail trading has a significantly higher cost per trade (see Figure 4.4.1.)

The figures have been derived from Table 4.4.1 and plotting revenues and costs for both retail and wholesale transactions at various numbers of transactions per annum and various transaction values. Generally, retail trades are for smaller amounts and banks incur higher trade costs and settlement costs per trade in this market. It is also evident from pricing structures that retail margins per trade are higher than wholesale margins (see Figure 4.4.2.) Not only is this a function of the deal sizes, but also indicative of greater competition in the wholesale market.

Amongst the larger corporate clients, it is not unusual for the customers to switch traders frequently. Wholesale trading is heavily dependent upon large volumes to compensate for low margins (see Figure 4.4.3), while retail trading operates on wider margins with lower volumes and values per trade (see Figure 4.4.4.) In both wholesale and retail trading, the higher the number of trades, the lower the cost per trade will be. In both cases, fixed costs are amortised more quickly with high volumes, but trade costs per transaction are generally higher in the retail market where trades are less frequent. At 80 000 transactions per annum in the wholesale market, fixed costs per transaction would amount to R250, while at 200 000 transactions per annum, fixed costs will reduce to R10 per transaction. (See Figure 4.4.5.)

Retail trading will yield the same fixed cost per transaction as in the wholesale market, but trade costs and settlement costs are substantially higher at R75 and R50 respectively as a result of less frequent trading and higher settlement costs. (See Figure 4.4.6.)

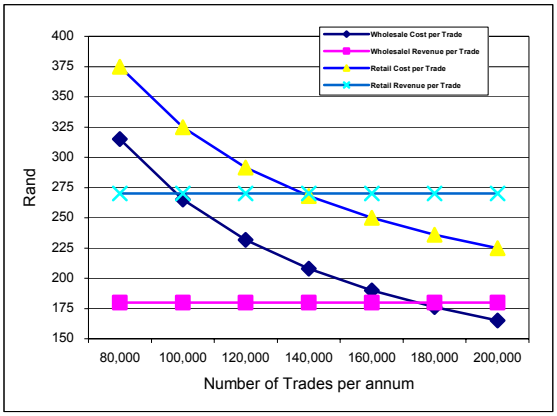
In summary, trading margins are narrow in the wholesale market, partly because of high value, high volume transactions and partly because switching costs for large corporate customers is low. Conversely, retail trading costs per unit are relatively high as deal size is small and trades are normally linked to existing relationships.

Table 4.4.1 Costs of executing and settling trade

Wholesale trading volumes and values				***Annual Turnover in Rand***		
	Wholesale	***Retail***		***Small Volume***	***Medium Volume***	***Large Volume***
Trade cost	15	75	Turnover	10,000,000,000	14,000,000,000	18,000,000,000
Settlement cost	0.05%	0.25%	Value	100,000	100,000	100,000
Sunk connectivity	20,000,000		Number	100,000	140,000	180,000
Fixed cost per trade				200	143	111
Variable			Trade	15	15	15
			Settlement	50	50	50
Total unit costs			Wholesale	265	208	176
Total costs				26,500,000	29,100,000	31,700,000
Revenue per trade			0.18%	180	180	180
Margins per trade %				-32%	-13%	2%
Wholesale revenue				18,000,000	25,200,000	32,400,000
Profits per trade				(85)	(28)	4
Profits				(8,500,000)	(3,900,000)	700,000
Retail trading volumes and values						
	Wholesale	**Retail**		***Small Volume***	***Medium Volume***	***Large Volume***
Trade cost	15	75	Turnover	2,000,000,000	2,800,000,000	3,600,000,000
Settlement cost	0.05%	0.25%	Value	20,000	20,000	20,000
Sunk connectivity	20,000,000		Number	100,000	140,000	180,000
Fixed cost per trade				200	143	111
			Trade	75	75	75
			Settlement	50	50	50
Total unit costs			Retail	325	268	236
Total costs				32,500,000	37,500,000	42,500,000
Revenue per trade			1.35%	270	270	270
Margins per trade %				-17%	1%	14%
Retail revenue				27,000,000	37,800,000	48,600,000
Profits per trade				(55)	2	34
Profits				(5,500,000)	300,000	6,100,000

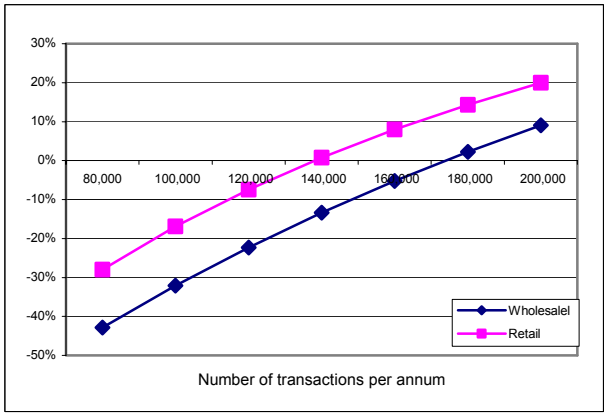
Source: Illustrative values

Figure 4.4.1 Wholesale / retail comparison of costs and revenues per trade



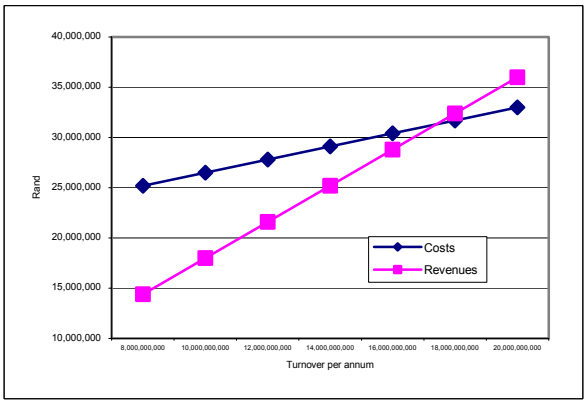
Source: Illustrative values

Figure 4.4.2 Margins earned per trading transaction



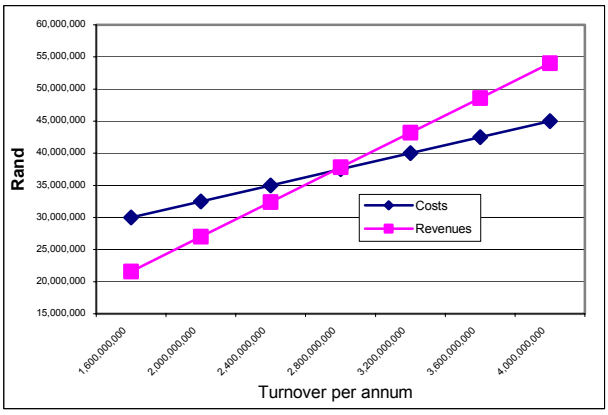
Source: Illustrative values

Figure 4.4.3 Wholesale trading break-even



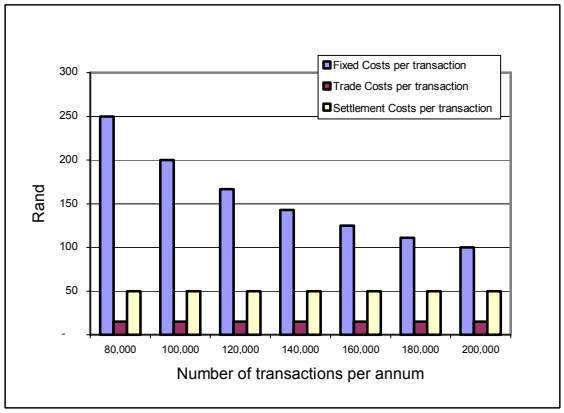
Source: Illustrative values

Figure 4.4.4 Retail trading break-even



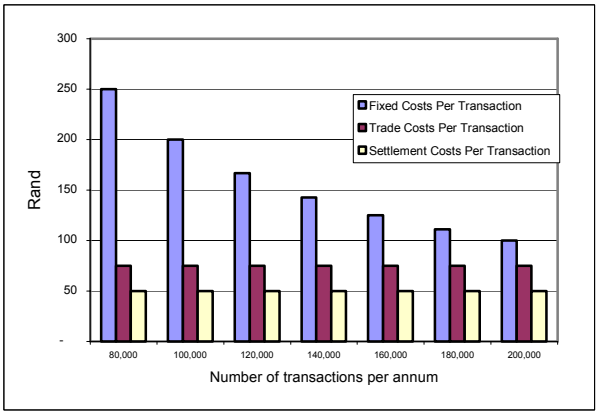
Source: Illustrative values

Figure 4.4.5 Wholesale costs per transaction



Source: Illustrative values

Figure 4.4.6 Retail costs per transaction



Source: Illustrative values

4.5 THE INTERMEDIATION PROCESS

Banks, as financial intermediaries, perform a crucial role between depositors and borrowers, which ultimately determines the level of interest rates. Real interest rates (i.e. the nominal rate adjusted for inflation) will either encourage or discourage savings or lending decisions. But likewise real tax rates will strongly influence savings or borrowing decisions in the economy.

Intermediation Model

Costs: Of the three parties in the intermediation process, the bank, as facilitator, will incur costs in attracting deposits, maintaining records, applying controls and ensuring adequate liquidity and solvency to repay these deposits. Banks therefore will seek to earn a margin between the risk-free investment rate (e.g. the Treasury Bill rate) and the rate paid to depositors. On the other hand, banks will seek to earn a margin between the risk-free rate and the rate at which it would be prepared to make funds available to borrowers. Apart from loan origination, maintenance and repayment costs, the bank will seek to price this facility to compensate for the risk of non-payment.

However, two variable factors in the intermediation process are beyond the control of the parties to intermediation, but which will strongly influence borrowing and lending costs, namely inflation and tax. Inflation erodes the purchasing power of monetary assets (this effect is often called the "inflation tax")

Crucial factors in the intermediation function are:

- **The rate of inflation.** In an inflationary environment, real borrowing costs decline as the inflation rate increases (see Figure 4.5.1). At an inflation rate of 2%, borrowers will be paying an effective rate of just under 8% while an inflation rate of 10% will lead to an effective after tax rate of slightly below zero for the borrower. Conversely, savers will only earn positive real rates of return when inflation is lower than 4%. Unless nominal interest rates exceed the inflation rate, the propensity to save will decline. Intermediation is usually a "zero sum game", i.e. what works to the advantage of the borrower is usually detrimental to the lender and *vice versa*. This factor is compounded where the borrower enjoys tax relief on the interest paid. Tax advantages will mean that it is not a zero sum game.
- **The tax on nominal savings.** Not only will negative real rates discourage savings, but also this negative factor will be compounded if the nominal interest on deposits is taxed at a standard rate irrespectively of the ruling inflation rate.
- **The degree of fiscal distortion.** The higher the taxation rate applicable to both depositors and borrowers, the greater will be the distortion between the nominal rates and the effective real rates (see Figure 4.5.2). At inflation rates in excess of about 6%, depositors will not enjoy real returns and there is therefore less incentive to save. Individual taxpayers enjoy the first R10 000 interest per annum as tax free, which does provide some relief.
- **The effect of volume vs margin.** Banks, as intermediaries, ensure their margins irrespectively of the ruling inflation rates and in Figure 4.5.3 it is seen that the bank margin of 5% will remain constant even though effective borrowing and deposit rates vary. Generally however, low inflation rates encourage more financial intermediation, which impacts positively on bank profits.
- **Fiscal generosity.** Where tax relief is granted to the depositor, savings will be promoted. And where tax deductions are allowed to the borrower, there will be a net cost to the fiscus (see Figure 4.5.3). The fiscus, in applying differential taxing to borrowers and depositors incurs a net loss of 2%.

As interest rates are also used as a policy instrument (e.g. to achieve a desired stimulus or brake on economic growth), significant shifts in the relative attractiveness of depositing or borrowing can occur over the business cycle. In the past high interest rate volatility and high inflation rates in the South African economy have eroded the personal discretionary saving base of the country. However, contractual savings, such as pension fund contributions have been largely unaffected. As a consequence savings deposits are effectively converted from retail deposits to wholesale deposits. This development leads to greater reliance by banks on wholesale funding, which raises the risk profile of the banking sector.

Poor performance of equity markets over the past few years has negatively affected pension performance and discretionary savings could be diverted to banks, provided real rates of interest can be maintained. Tax incentives in the pension industry have not been extended to discretionary savings in banks, leaving an unlevel playing field in competition for savings.

Table 4.5.1 The intermediation process

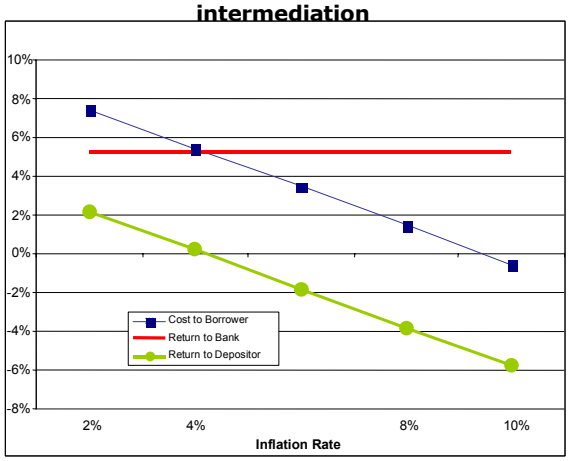
Dynamics of the intermediation process

Corporate borrower and personal depositor

Assumptions		*Scenario 1*	*Scenario 2*	*Scenario 3*	*Scenario 4*	*Scenario 5*
Capital amount		1,000	1,000	1,000	1,000	1,000
Nominal lending costs		13.50%	13.50%	13.50%	13.50%	13.50%
Inflation		2%	4%	6%	8%	10%
Taxation		30%	30%	30%	30%	30%
Money market rate		10%	10%	10%	10%	10%
Depositor rate paid		6%	6%	6%	6%	6%
Borrower:	Net cost	(74.50)	(54.50)	(34.50)	(14.50)	5.50
	%	-7.5%	-5.5%	-3.5%	-1.5%	0.6%
Bank as	Net gain	52.50	52.50	52.50	52.50	52.50
Intermediator	%	5.3%	5.3%	5.3%	5.3%	5.3%
Taxation:	On bank	22.50	22.50	22.50	22.50	22.50
	On borrower	(40.50)	(40.50)	(40.50)	(40.50)	(40.50)
	On depositor	-	-	-	-	-
	Net	(18.00)	(18.00)	(18.00)	(18.00)	(18.00)
	%	-1.8%	-1.8%	-1.8%	-1.8%	-1.8%
Depositor:	Net gain	40.00	20.00	-	(20.00)	(40.00)
		4.0%	2.0%	0.0%	-2.0%	-4.0%

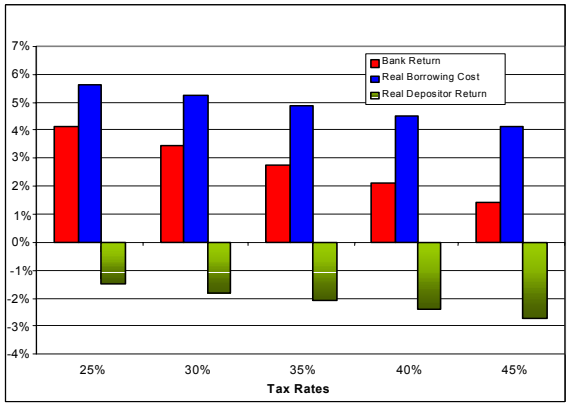
Source: Illustrative values

Figure 4.5.1 Real costs and returns in intermediation



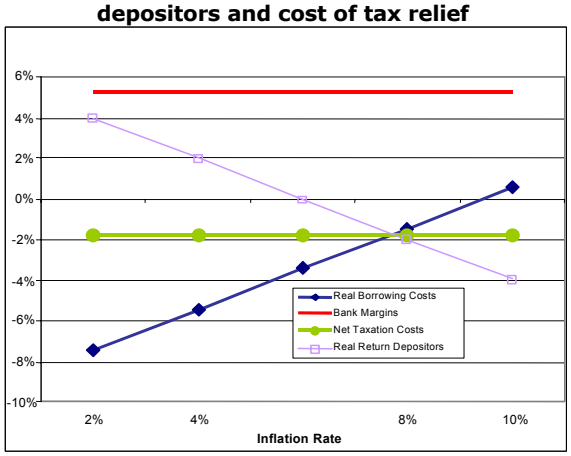
Source: Illustrative values

Figure 4.5.2 Real lending and deposit rates at different tax rates



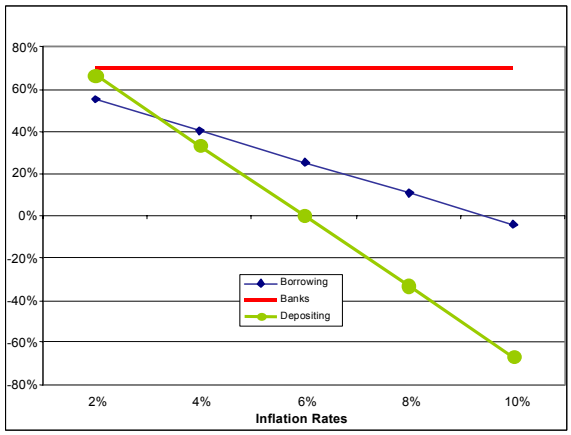
Source: Illustrative values

Figure 4.5.3 Real returns to borrowers and depositors and cost of tax relief



Source: Illustrative values

Figure 4.5.4 Effective rates relative to nominal rates



Source: Illustrative values

Chapter 5

Simulation: The possible role of second- and third-tier banks[1]

This chapter consists of the following sections:

1. Revenue and cost drivers of Postbank.
2. Revenue and cost drivers of a cellphone company or mass retailer.
3. Revenue and cost drivers of a micro-lender.
4. Revenue and cost drivers of an internet service provider.

The aim of this chapter is to identify the critical success factors in the provision of savings accounts by second and third tier banks, and to explore the economic viability of different providers. The models explore the impact that changes in the number of transactions, turnover and the balance per account have on the economic viability of each potential service provider.

The simulations provided here assume similar operating costs to those experienced by traditional commercial banks with branch infrastructure, and the associated mix of fixed and variable costs. This framework may exaggerate the costs experienced by potential new entrants utilising different business models. The simulations indicate that new business models representing a radical departure from traditional banking may be necessary to cater for the potential account holders whose needs are currently not met by the existing banks. This underpins the importance of the expansion of licensing to allow for second and third tier banks to address the provision of low-cost saving accounts.

Critical factors in the successful delivery of provision of low-cost savings accounts by second and third tier banks include:

- **Low-cost opening, closing and maintenance of accounts**. To these factors must be added the expected life of the account and the level of functionality required for an entry-level account.
- **Critical mass in the number of accounts**. It is estimated that more than two million accounts will be required before positive returns can be expected for Postbank.
- **Ability to levy transaction fees for cash withdrawals**, given that interest margin on low-balance accounts would be insufficient to defray operating costs.
- **Adequate mark-ups on outsourced processing fees.** For example, if there are fewer than two withdrawals per month, compensating higher balances will need to be maintained or lower interest rates will need to be charged to break even.
- **The rate at which accounts are opened and closed**. Short-duration accounts may not be viable to the offering institution.
- **Minimisation of infrastructural costs.** The replication of an ATM network and electronic transmission facilities will negate any financial benefits to the supplier.
- The viability of operating low-cost savings accounts is more dependent upon **the number of transactions over the account rather than the amount of money in the account**. This factor suggests that these accounts are relatively interest rate insensitive and real interest rates can be offered in this market to enable the saver to achieve the objective of capital preservation.
- Any potential entrant in the market to provide low-cost savings accounts to the general public will need **to extract synergies from their existing business** in order to keep operating costs as low as possible. In other words potential suppliers would need to employ their existing client base and technologies to reduce their cost structures.
- Any dedicated savings bank would **need access to the National Payments System** which serves to connect both beneficiaries and payers into a dynamic clearing system.

[1] In contrast to first-tier banks (which typically operate on the full spectrum of e.g. credit-risk, liquidity-risk, interest-rate risk, and currency risk management), *second-tier* banks are prohibited to use public deposit for (illiquid) lending to the private sector. *Second-tier* banks may be "narrow" or "core" banks: In case of a so-called "narrow" bank all deposits liabilities are invested in approved highly-liquid money-market instruments and no other credit business is allowed, while so-called "core" banks can engage in lending to the private sector provided such loans are funded from their second-tier capital (in essence the core banks' subordinated debt). For more detail see: Bossone, B., "Should Banks be Narrowed?", IMF Working Paper, WP/01/159, Washington, 2001. *Third-tier* banks, like first-tier banks, can use deposit liabilities for lending to the private sector, but only if their depositors and lenders are from the same community. In essence *third-tier* banks are relatively smallish operations such as village banks, stokvels (rotating saving schemes), community banks, small local mutual building societies, and co-operative banks. The key issue here is that the possible bankruptcy of a *third-tier* bank should have no systemic risk whatsoever for the financial sector at large. An important difference between first-tier and lower-tiered banks is the philosophy of the legislation supporting their daily operations. Stated somewhat in the extreme: in the case of first-tier banks everything is allowed unless prohibited in law, while for lower-tiered banks everything is prohibited unless specifically permitted in terms of legislation.

Postbank is offered as an example of a dedicated savings bank.

The Postbank already has a wide geographic footprint through the Post Offices. It is in the process of expanding its ATM network, but this will result in a severe cost burden on the Postbank. Table 5.1 below and the associated Figures 5.1.1 to 5.1.4 indicate that the delivery of low-cost savings accounts is a viable proposition, provided processing and delivery is outsourced to existing service providers.

The assumptions in Table 5.1 are based upon the Postbank complying with a capital adequacy ratio of 10% of risk assets (as per expected requirements under the proposed second-tier Banks Act, also referred to as the Dedicated Banks Act). As assets are essentially interbank deposits and government bonds, risk assets are low. The observations and comments on the critical factors in the successful delivery of low-cost savings accounts are applicable to a dedicated savings (or narrow) bank, and indicate that the operation of such a bank can be viable and will not need State subsidies to prosper.
Figure 5.1.1 shows that approximately 2 million accounts will be needed to achieve break even in the operation. It is further noted that, even with more than 2 million accounts, enhanced profitability will only be achieved with increasing transaction volumes (Figure 5.1.2) reduced account turnover (Figure 5.1.3) and attracting higher balances per account (Figure 5.1.4). Any combination of these variables will impact upon the successful entry into this market by the Postbank.

Table 5.1 Assumptions underlying the operation of a Dedicated Savings bank

Deposit Periods	Investment yield	Deposit Rate	Interest Margin on Deposits	Deposit Distribution	Deposit Analysis
Vaults + Cash	0.00%	5%	-5.00%	2.50%	50,000,000
Demand	8.00%	5%	3.00%	63.48%	1,269,600,000
Short	8.25%	5%	3.25%	13.35%	267,000,000
Medium	8.25%	5%	3.25%	9.42%	188,400,000
Medium	8.50%	5%	3.50%	9.94%	198,800,000
Long	8.50%	5%	3.50%	1.31%	26,200,000
				100.00%	2,000,000,000

Assumptions

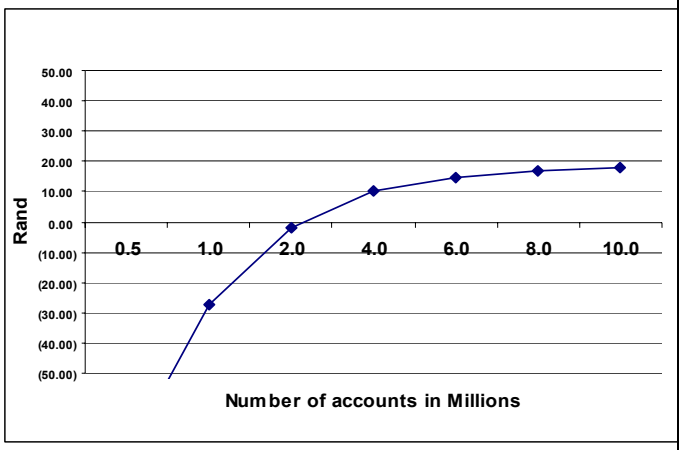
Operating Assumptions

Infrastructure Costs in Rand	50,000,000
Income Tax percentage	30%
Cash held in vaults	2.50%
Provision for losses as % of private sector investments	0.05%
Required Capital (10% of risk weighted Assets + Infrastructure)	90,000,000
Accounts opened/closed pa	5%
Deposits per account per month	1
Withdrawals per account per month	4
Average balance per account	500
Number of accounts	4,000,000

Cost Assumptions

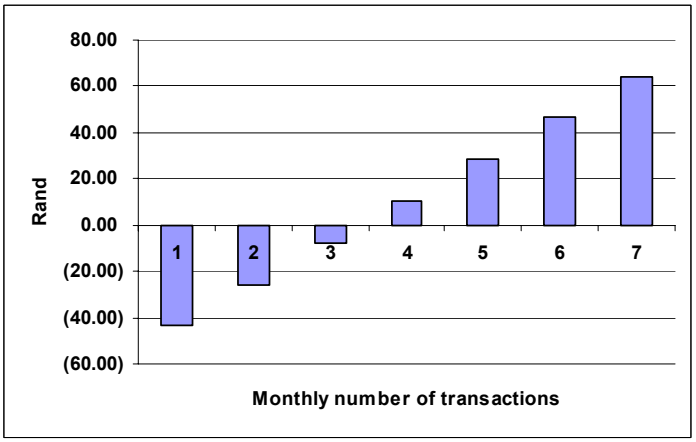
Operating Costs	Per Item	Annual Costs
Account opening	50	10,000,000
Account closing	20	4,000,000
Deposit costs	5	240,000,000
Withdrawal costs	4	768,000,000
		1,022,000,000
Fixed Overhead & Admin	Per annum	50,000,000
Account maint cost pa	66	264,000,000
(20% of Accounts dormant)		1,336,000,000
Fee income per transaction.	5.5	1,320,000,000

Figure 5.1.1 Annual contribution per account for varying number of accounts



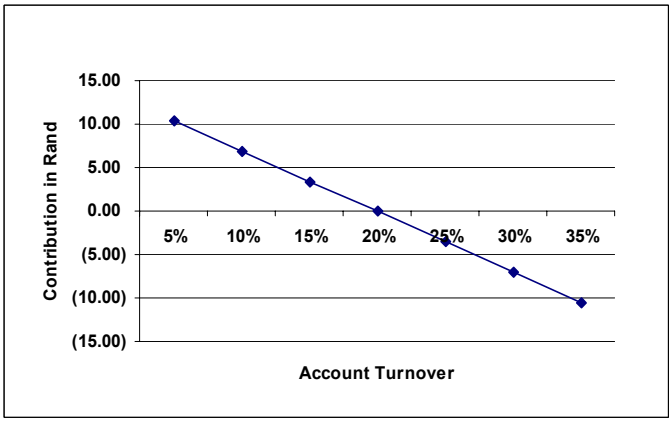
Source: Illustrative values

Figure 5.1.2 Annual contribution per account for varying number of monthly transactions



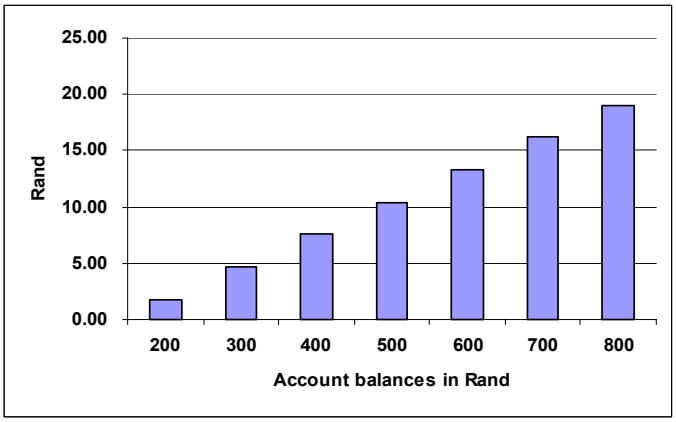
Source: Illustrative Values

Figure 5.1.3 Annual contribution per account based on percentage of accounts opened and closed



Source: Illustrative Values

Figure 5.1.4 Annual contribution per account with varying balances and four withdrawals per month



Source: Illustrative Values

Operating structures and balance sheet and income statement of a dedicated savings bank (PostBank)

Interest Margins
A savings bank that invests primarily in readily realisable liquid assets and short-term funds, and pays a real rate of interest on deposits is expected to earn a margin of about 3%. This is somewhat lower than the 4% to 5% that a high street bank will earn, on average, but margins in the wholesale market are generally lower than those in the retail market. High retail margins are usually geared to compensating high street banks for the costs of operating retail deposit accounts.

Operating revenues and costs
Most high street banks manage their operating costs at approximately 60% of their total revenues. A savings bank operating under the assumptions in Table 5.1 will incur costs at about 97% of revenue. This high ratio demonstrates the need to achieve critical mass in the number of accounts and the number of transactions processed by the savings bank. Because of the low regulatory capital requirement of the savings bank, adequate returns can still be generated at relatively high cost structures. The savings bank, in order to be viable and cost effective would outsource transactions and account administration to existing service providers. The cost of deposit insurance have been excluded from the operating assumptions as deposits in the Post Office are likely to carry an implied Government guarantee.

Profitability ratios
In spite of low interest margins and high operating costs, a savings bank can still yield a return on equity of 24%. This is largely because the equity required to be held against low-risk assets is only about 4% of total assets, whereas high street banks, with a higher proportion of higher risk assets, would average about 8% to 10% of total assets.

It can be seen from the accompanying graphs that a savings bank is highly sensitive to the number of accounts opened and closed per annum, which, if increased to 20% per annum, could destroy all profits. Inactive and low balance accounts, with fewer than 4 transactions per month will also severely impact profitability.

Structure of balance sheet
High street banks will invariably have a mix of assets more heavily weighted towards loans and advances, with about 60% of total assets in this category. A dedicated savings bank will have no loans and advances, but will have more than 90% of its assets in liquid and low-risk funds. Part of these funds is redeposited with other commercial banks to provide liquidity for withdrawals using other bank's cash terminals. These deposits are low risk, but an assumption is made that provision for losses of 0,05% is required. This assumption is not carried forward into other simulations as it has little impact on the analysis.

Key success factors
Cost containment within the requirement of achieving a critical mass of accounts and transactions, and minimising infrastructural expenditure by outsourcing will be the most critical issues for success.

If the Postbank seeks to replicate a large ATM network, the additional cash outlay, in the form of infrastructural capital will substantially reduce profitability.

Table 5.1.1 Estimated balance sheet and income statement of a dedicated savings bank

Balance Sheet		**Basic Income Statement**	
Assets	**R**		**R**
		Interest Income	158,263,500
Cash & short term assets	1,319,600,000	Interest Expense	100,000,000
Short-term money market assets	69,140,090	**Net Interest Income**	**58,263,500**
Advances			
Liquid assets and other securities	680,400,000	Provision for losses on private sector investments	634,800
Other Assets	50,000,000	**Income from Deposits and Investments**	**57,628,700**
Investments	0		
Total Assets	2,119,140,090	Non-Interest Income	1,320,000,000
Liabilities		**Operating Income**	**1,377,628,700**
Deposits and current accounts	2,000,000,000		
Deferred Taxation	0	Operating Expenditure	1,336,000,000
Taxation	0	**Net Income before taxation**	**41,628,700**
Provisions for liabilities and charges	0	Taxation	12,488,610
Total Liabilities	2,000,000,000	**Net Income after taxation**	**29,140,090**
Shareholders funds			
Share Capital	90,000,000	Return on capital	24.46%
Reserves	29,140,090	Interest margin	2.7%
Shareholders ' funds	119,140,090	Operating Cost to revenue	97%
Total Liabilities and shareholders funds	**2,119,140,090**	**Deposit base**	**2,000,000,000**

5.2 REVENUE AND COST DRIVERS OF A CELLPHONE COMPANY OR MASS RETAILER

Cellphone companies or mass retailers are considered here as possible examples of **quasi savings banks** where savings accounts are not the core business of the institution, but may be complementary to that business.

An analysis of revenues and costs has been undertaken below. It is assumed that the bank will be restricted to matching its deposits with interbank assets and short-term government bonds to ensure low-risk and adequate liquidity.

Refer to Table 5.2.1 and Figures 5.2.1 to 5.2.4.

Based on the assumptions of Table 5.2.1, a cell phone company or a mass retailer can operate successfully as a core bank (i.e. in a separate capitalised subsidiary, which operates under the proposed Dedicated Banks Act). For the same volume of accounts and the same profile of transactions and balances as the Postbank, these institutions could more than double the expected earnings of the Postbank.

The main drivers of this increased profitability are:

- An existing client base and the reach to service this base.
- The technology to effect the transfers.
- Existing capability to handle large volumes of cash.
- Sales of prepaid cards and maintaining client accounts mean that cellphone companies have good administrative capacity.

These factors lead to lower account opening and maintenance costs, thereby lowering the break even volumes and balances required to be maintained. It would probably be necessary for these institutions to be a party to some form of deposit insurance and this has been factored into the costs. For these institutions it has been assumed that none of the deposits raised will be deployed in the business of the institution.

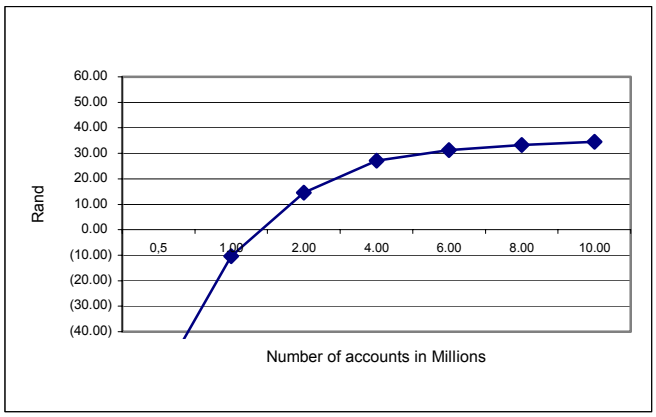
Figure 5.2.1 shows that on the same assumptions as made for the Postbank, break even can be expected to be achieved after operating only 1 million accounts. Furthermore, the operator has an assumed cost structure that is not as sensitive to the number of transactions (Figure 5.2.2), nor the rate at which accounts are opened and closed, nor the average balance per account (Figures 5.2.3 and 5.2.4.). The main reason for these conclusions is that an existing client base and infrastructure can be leveraged to provide low-cost savings accounts relatively profitably.

Table 5.2.1 Assumptions underlying the operation of a savings bank operated by a cellphone operator or retailer.

Deposit Periods	Investment yield	Deposit Rate	Interest Margin on Deposits	Deposit Distribution, %	Deposit R
Vaults + Cash	0.00%	5%	-5.00%	2.50%	50,000,000
Demand	8.00%	5%	3.00%	63.48%	1,269,600,000
Short	8.25%	5%	3.25%	13.35%	267,000,000
Medium	8.25%	5%	3.25%	9.42%	188,400,000
Medium	8.50%	5%	3.50%	9.94%	198,800,000
Long	8.50%	5%	3.50%	1.31%	26,200,000
				100.00%	2,000,000,000

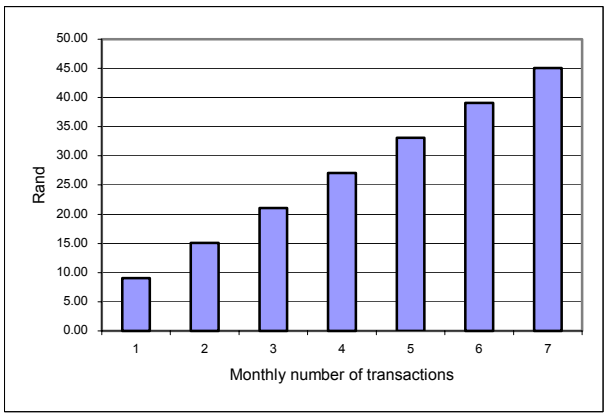
Operating Assumptions		Cost Assumptions		
Infrastructure Costs in Rand	20,000,000	Operating Costs	Per Item	Annual Costs
Income Tax % percentage	30%	Account opening	10	2,000,000
Cash held in vaults	2.50%	Account closing	10	2,000,000
Premium for Deposit Insurance	1%	Deposit costs	2	96,000,000
Required capital (10% of risk weighted assets+ Infrastructure	60,000,000	Withdrawal	5	960,000,000
Accounts opened/closed pa	5%	costs		1,060,000,000
Deposits per account per month	1	Fixed Overhead & Admin	Per annum	50,000,000
Withdrawals per account per month	4	Account maint cost pa	35	140,000,000
Average balance per account	500	(20% of Accounts dormant)		1,250,000,000
Number of accounts	4,000,000	Fee income per transaction	5.5	1,320,000,000

Figure 5.2.1 Annual contribution per account for varying number of accounts



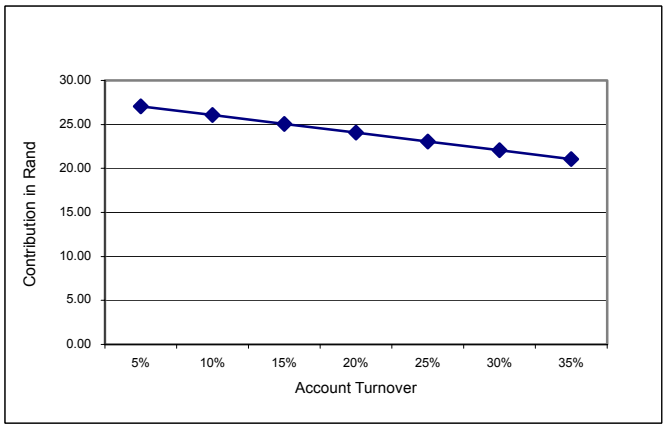
Source: Illustrative Values

Figure 5.2.2 Annual contribution per account for varying number of monthly transactions



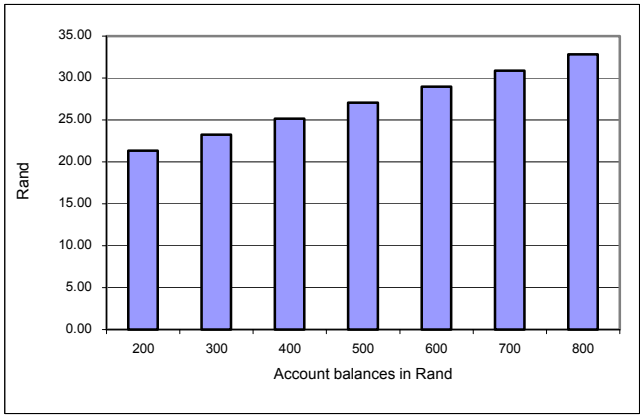
Source: Illustrative Values

Figure 5.2.3 Annual contribution per account based on percentage of accounts opened and closed



Source: Illustrative Values

Figure 5.2.4 Annual contribution per account with varying balances and four withdrawals per month



Source: Illustrative Values

Operating structures and balance sheet and income statement of a Cellphone Company of Retailer

Interest Margins
Interest margins for a cellphone operator or retailer, that provides a dedicated savings bank service will be the same as those expected for the Postbank. This is because deposits will be invested in readily realisable liquid assets and short-term funds. Interest rates paid on deposits are expected to be the same as those on deposits in the Postbank, but higher than those of high street banks.

Operating revenues and costs
As the operating model for the Postbank assumes the same activities as for the cellphone operator or retailer, operating revenues and costs will be similar for both categories. However, retailers and cellphone operators are expected to have lower account opening, closing and admin costs because they would probably leverage their operations off an existing client base. This factor results in cellphone operators and retailers expected to experience cost to revenue ratios of about 92%, compared to 97% for the Postbank. The cost assumptions for cellphone operators and retailers may be conservative, particularly where transmission capability already exists in cell phones and cash handling is a core competency of retailers. A cost for deposit insurance premiums has been allowed, particularly where operators in this category may be seen by the depositing public to be higher risk than the Postbank.

Profitability ratios
Because of the lower infrastructure costs required, compared to the Postbank and expected lower operating costs off an existing customer base, a return on equity employer could be a high as 56% per annum, compared to the Postbank's expected 24% per annum.

It can be seen from the accompanying graphs that a cellphone operator or a retailer can operate profitably at lower volumes than the Postbank and is less sensitive than the Postbank to account closures and transaction volumes.

Structure of balance sheet
The structure of a cellphone or retail operated bank investing in low-risk assets will be very similar to that of the Postbank. Consequently, there will be very little risk of loss in the assets of both types of banks. Capital requirements will be similar for both types of bank, but that portion of a cellphone operator or retailer's capital required for infrastructure will be lower as a result of having existing and compatible infrastructures.

Key success factors
Leveraging off the existing customer base will be an important consideration, as will be the operator's ability to utilise existing competencies and infrastructure to contain operating costs. In these circumstances, lower outsourcing costs will be incurred.

Table 5.2.2 Estimated balance sheet and income statement of cellphone company or retailer

Balance Sheet

Assets	**R**
Cash & short term assets	131,960,000
Short-term money market assets	1,303,424,450
Advances (Reduction in External Funding)	-
Liquid assets and other securities	680,400,000
Other Assets	20,000,000
Investments	
Total Assets	2,135,784,450
Liabilities	
Deposits and current accounts	2,000,000,000
Taxation	0
Provisions for liabilities and charges	0
Debentures	0
Total Liabilities	2,000,000,000
Shareholders funds	
Share Capital	60,000,000
Reserves	75,784,450
Shareholders' funds	135,784,450
Total Liabilities and shareholders funds	**2,135,784,450**

Basic Income Statement

	R
Interest Income	158,263,500
Interest Expense	100,000,000
Net Interest Income	**58,263,500**
Premium for Deposit Insurance	20,000,000
Income from Deposits and Investments	**38,263,500**
Non- Interest Income	1,320,000,000
Operating Income	**1,358,263,500**
Operating Expenditure	1,250,000,000
Net Income before taxation	**108,263,500**
Taxation	32,479,050
Net Income after taxation	**75,784,450**
Return on capital	55.81%
Interest margin	2.7%
Operating Cost to revenue	92%
Deposit base	**2,000,000,000**

5.3 REVENUE AND COST DRIVERS OF A MICRO-LENDER

This section simulates the assumed condition of a hypothetical micro-lender that operates independently of a bank or retailer. It is not based upon the actual financial profile of micro-lenders in South Africa.

On the basis of similar operating assumptions as for the Postbank and cell phone and mass retail operators, the profitability of micro-lenders undertaking deposit taking, appears less likely. However it should be noted that this conclusion is based on the assumption of similar operating costs to those of a big commercial bank, which may not be appropriate.

The customer base of the micro-lender is traditionally a borrower, and not a saver. Therefore a new customer base, with different behaviours and requirements will need to be built. In addition micro-lenders are unlikely to have, or develop, the technology for automated delivery and processing. For example, micro-lenders may not have access to a viable ATM infrastructure. Deposit account acquisition and maintenance costs are likely to be higher than those expected for cell phone operators and retailers as micro-lenders are unlikely to have processing synergy with their existing client base. The nature of the combined business will probably result in a need to adopt deposit insurance.

The net result, on the basis of the assumptions in Table 5.3.1 and 5.3.2 is that it is unlikely that all micro-lenders will be successful in the provision of low-cost savings accounts. In fact, only for a handful of the largest micro-lenders is banking for the lower-income earners a business proposition.

The analysis that follows assumes, that the micro-lender will operate a savings bank with all deposits invested in low-risk assets. Refer to Table 5.3.1 and Figures 5.3.1 to 5.3.4.

A micro-lender operating as a restricted bank is unlikely to do much better than break even, particularly as account opening, maintenance and operating costs are expected to be above those of the Postbank, cell phone operators and mass retailers. Critical mass, under these conditions increases to approximately 4 million accounts. It is suggested that the development of a savings culture over a period of time will enhance a micro-lender's ability to provide a one-stop service to customers. In the light of currently perceived low levels of synergy with existing businesses, it is seen from Figure 5.3.1 that, even though the number of accounts required to break even is estimated at 4 million, the contribution per account does not rise significantly above about R10 per account. High balance accounts as seen in Figure 5.3.4 and high volume transactions as seen in Figure 5.5.2 will improve expected results.

Table 5.3.1 Assumptions underlying the operation of a Savings bank operated by a Micro-lender

Deposit Periods	Investment yield	Deposit Rate	Interest Margin on Deposits	Deposit Distribution	Deposit Analysis
Vaults + Cash	0.00%	5%	-5.00%	2.50%	50,000,000
Demand	8.00%	5%	3.00%	63.48%	1,269,600,000
Short	8.25%	5%	3.25%	13.35%	267,000,000
Medium	8.25%	5%	3.25%	9.42%	188,400,000
Medium	8.50%	5%	3.50%	9.94%	198,800,000
Long	8.50%	5%	3.50%	1.31%	26,200,000
				100.00%	2,000,000,000

Assumptions

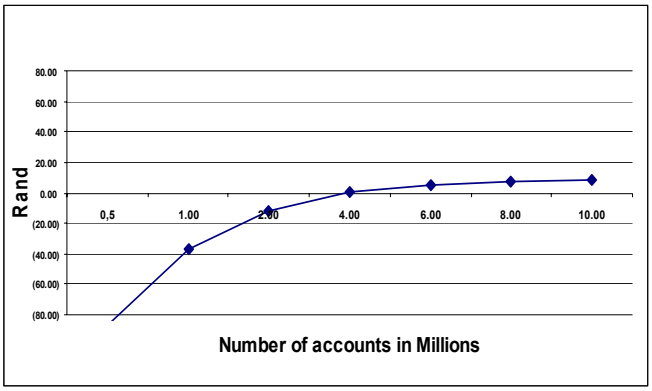
Operating Assumptions

Infrastructure Costs in Rand	20,000,000
Income Tax percentage	30%
Cash held in vaults	2.50%
Premium for Deposit Insurance	1%
Required capital (10% of risk weighted assets + Infrastructure)	60,000,000
Accounts opened/closed pa	5%
Deposits per account per month	1
Withdrawals per account per month	4
Average balance per account	500
Number of accounts	4,000,000
Provision for bad debts/losses	0%

Cost Assumptions

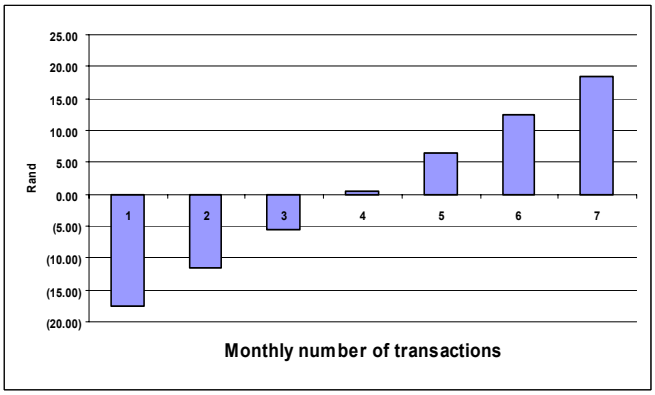
Operating Costs	Per Item	Annual Costs
Account opening	30	6,000,000
Account closing	20	4,000,000
Deposit costs	2	96,000,000
Withdrawal costs	5	960,000,000
Activity costs		1,066,000,000
Fixed Overhead & Admin	Per annum	50,000,000
Account maint cost pa	60	240,000,000
(20% of Accounts dormant)		1,356,000,000
Fee income per transaction.	5.5	1,320,000,000

Figure 5.3.1 Annual contribution per account for varying number of accounts



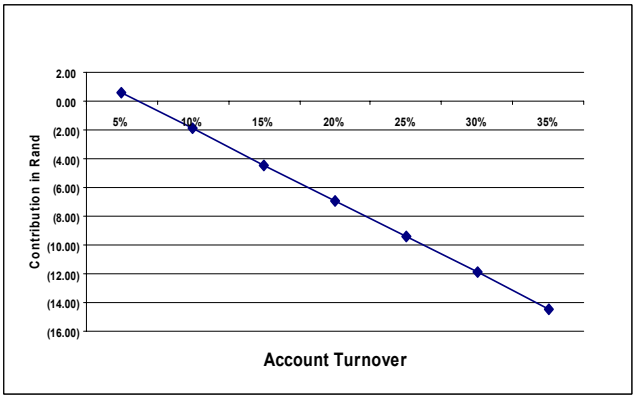
Source: Illustrative values

Figure 5.3.2 Annual contribution per account for varying number of monthly transactions



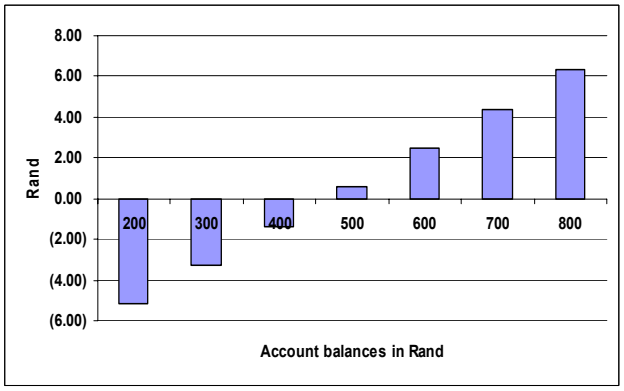
Source: Illustrative values

Figure 5.3.3 Annual contribution per account based on percentage of accounts opened and closed



Source: Illustrative values

Figure 5.3.4 Annual contribution per account with varying balances and four withdrawals per month



Source: Illustrative values

Interest Margins
Interest margins for a micro-lender operating a dedicated savings bank should be the same as those that will be experienced by the Postbank, a cellphone operator or a retailer, where such operators invest all their deposits in low-risk, readily realisable assets. It may be possible for the micro-lender to consider lowering the deposit rate paid, where there is a perception that the build-up of deposit accounts are providing qualifying histories for loan account accessibility. Without this linkage, interest margins could be as low as 2.8%.

Operating revenues and costs
Operating costs are assumed to be materially higher than those of a cellphone operator or a retailer. The reason for this is that the depositing customer base has a different profile to that of a borrowing customer. This implies higher start-up costs, and initial infrastructural costs. A cost for deposit insurance premiums has also been allowed, particularly where operators in this category may be seen by the depositing public to be higher risk than the Postbank or another dedicated savings bank. Unless operating synergies can be extracted from existing micro loan business processes, only the largest institutions will become profitable.

Profitability ratios
The establishment of a dedicated savings bank by a micro-lender or any other institution for that matter, will yield a minimal return, (2.6% per annum) on the equity required to set up and operate the institution. Perhaps the largest single factor against the set-up of dedicated savings banks by micro-lenders could be the public perception of risk to their deposits. Unless the technologies and methodologies developed for loan disbursement and instalment collections can be adapted for deposit receipt and withdrawals, the operations may struggle to achieve anything more than break even.

Structure of balance sheet
The balance sheet of a micro-lender operating a dedicated savings bank will be very similar to that of the Post Office, a retailer or a cellphone operator.

Key success factors
A micro-lender seeking to migrate to a multi-service financial institution would probably only look at a dedicated savings bank as a transition to an integrated financial service provider. Leveraging off the existing customer disbursement and collections processes will be an important consideration, as will be the micro-lenders access to a reasonable funds transmission service.

Table 5.3.2 Estimated balance sheet and income statement of a micro-lender

Balance Sheet

Assets	**R**
Cash & short term assets	131,960,000
Short-term money market assets	569,424,450
Short-term funds and Interbank	1,000,000,000
Liquid assets and other securities	340,200,000
Other Assets	20,000,000
Investments	
Total Assets	2,061,584,450
Liabilities	
Deposits and current accounts	2,000,000,000
Taxation	0
Provisions for liabilities and charges	0
Debentures	0
Total Liabilities	2,000,000,000
Shareholders funds	
Share Capital	60,000,000
Reserves	1,584,450
Shareholders' funds	61,584,450
Total Liabilities and shareholders funds	**2,061,584,450**

Basic Income Statement

	R
Interest Income	158,263,500
Interest Expense	100,000,000
Net Interest Income	**58,263,500**
Premium for Deposit Insurance	20,000,000
Income from Deposits and Investments	**38,263,500**
Non-Interest Income	1,320,000,000
Operating Income	**1,358,263,500**
Operating Expenditure	1,356,000,000
Net Income before taxation	**2,263,500**
Taxation	679,050
Net Income after taxation	**1,584,450**
Return on capital	2.57%
Interest margin	2.8%
Operating Cost to revenue	100%
Deposit base	**2,000,000,000**

It is assumed that deposits with the internet service provider are re-invested in low-risk assets.

It is unlikely that internet banking will be extended to the lower income groups in the near future. This is largely because access to the internet is not yet freely available and the volume of potential users is still low. Unit costs will therefore be high. Based on the assumptions in Table 5.4, there would need to be in excess of 1 million users of this service in order for the provider to break even (Figure 5.4.1). Internet banking providers may be able to reduce the number of accounts required to break even if volumes of electronic payments are increased. (Figure 5.4.2.)

Development and infrastructure costs as well as connectivity could exceed R100 million for a service provider. However, as seen in Figure 5.4.1, once the break even number of accounts of 1 million is reached, there is greater potential for enhanced returns at higher volumes than with micro-lenders, retailers and cellphone providers. Because communications technology is compatible with account payment technology, the greater the number of monthly transactions, the greater the profitability of the accounts maintained. These contributions can exceed R80 per account where 7 or more transactions are undertaken per month (Figure 5.4.2).

Table 5.4 Underlying the operation of a Savings bank operated by an Internet Service Provider

Deposit Periods	Investment yield	Deposit Rate	Interest Margin on Deposits	Deposit Distribution	Deposit Analysis
Vaults + Cash	0.00%	5%	-5.00%	2.50%	50,000,000
Demand	8.00%	5%	3.00%	63.48%	1,269,600,000
Short	8.25%	5%	3.25%	13.35%	267,000,000
Medium	8.25%	5%	3.25%	9.42%	188,400,000
Medium	8.50%	5%	3.50%	9.94%	198,800,000
Long	8.50%	5%	3.50%	1.31%	26,200,000
				100.00%	2,000,000,000

Assumptions

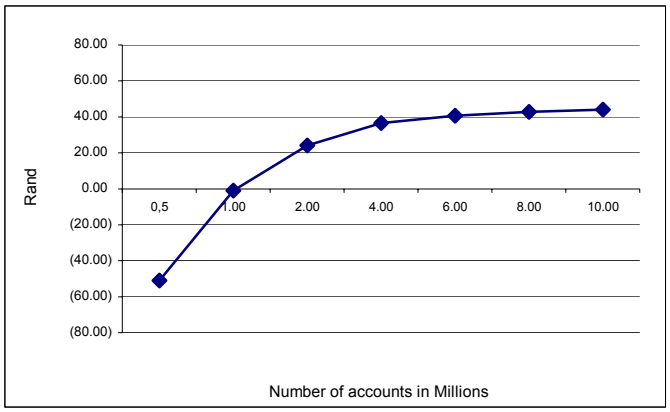
Operating Assumptions

Infrastructure Costs in Rand	100,000,000
Income Tax percentage	30%
Cash held in vaults	2.50%
Premium for Deposit Insurance	1%
Required capital (10% of risk weighted assets + Infrastructure)	140,000,000
Accounts opened/closed pa	5%
Deposits per account per month	1
Withdrawals per account per month	4
Average balance per account	500
Number of accounts	4,000,000
Provision for bad debts/losses	0%

Cost Assumptions

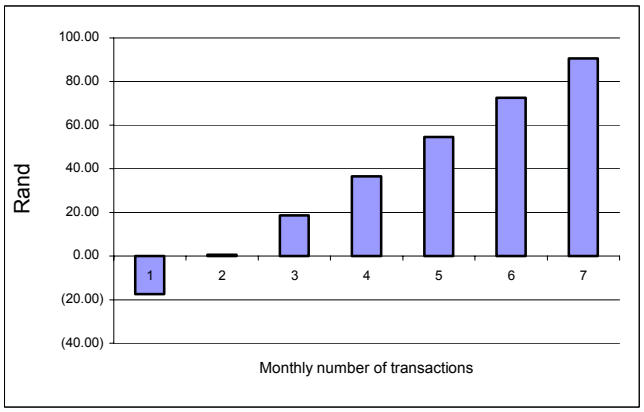
Operating Costs	Per Item	Annual Costs
Account opening	30	6,000,000
Account closing	20	4,000,000
Deposit costs	2	96,000,000
Withdrawal costs	3	576,000,000
Activity costs		682,000,000
Fixed Overhead & Admin	Per annum	50,000,000
Account maint cost pa	60	240,000,000
(20% of Accounts dormant)		972,000,000
Fee income per transaction.	4.5	1,080,000,000

Figure 5.4.1 Annual contribution per account for varying number of accounts



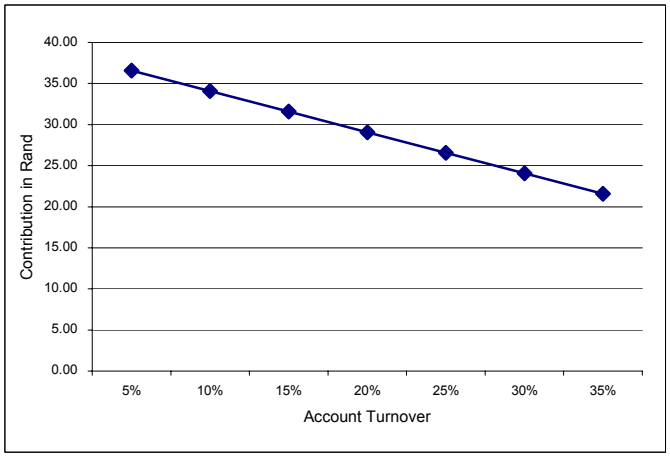
Source: illustrative values

Figure 5.4.2 Annual contribution per account for varying number of monthly transactions



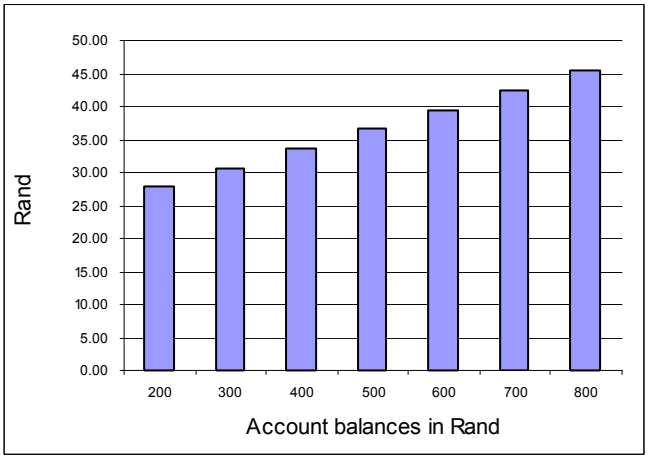
Source: Illustrative values

Figure 5.4.3 Annual contribution per account based on percentage of accounts opened and closed



Source: Illustrative values

Figure 5.4.4 Annual contribution per account with varying balances and four withdrawals per month



Source: Illustrative values

Interest Margins
Interest margins for internet service providers are likely to be similar to those expected for the Postbank, retailers, and cellphone operators (approximately 2,6% per annum).

Operating revenues and costs
Operating costs are assumed to be materially lower than those of a micro-lender, partly because most of the transactions and transfers will be electronic, and partly because accounts are expected to remain open for longer periods of time than those maintained by micro-lenders. Furthermore, there is no cash handling for internet transactions and this factor reduces transaction costs. These factors improve the ratio of operating costs to revenue from close to 100% for micro-lenders to about 87% for internet service providers. In most scenarios, the annual profitability is enhanced where numbers of accounts exceed 1 million and accounts are more active.

Profitability ratios
The establishment and operation of an Internet bank is likely to result in a return of about 42% per annum on the equity employed. These results are, however dependent upon achieving critical mass in account numbers and transaction numbers. Generally development costs are high and require income-generating volumes to become profitable.

Structure of balance sheet
The balance sheet of an internet service provider operating as a bank that accepts deposits will be very similar to that of any other service provider that utilises its deposits for investment in readily realisable liquid assets

Key success factors
An internet service provider will need to achieve critical mass of approximately 1 million accounts. As Internet access by the general population is rather restricted, growth to this number of accounts is unlikely in the short term. Furthermore, most banks offering Internet banking already have connectivity to settlement and payment systems.

Table 5.4.1 Estimated balance sheet and income statement of an Internet Service Provider

Balance Sheet

Assets	**R**
Cash & short term assets	131,960,000
Short-term money market assets	670,224,450
Short-term funds and Interbank	1,000,000,000
Liquid assets and other securities	340,200,000
Other Assets	100,000,000
Investments	
Total Assets	2,242,384,450
Liabilities	
Deposits and current accounts	2,000,000,000
Taxation	0
Provisions for liabilities and charges	0
Debentures	0
Total Liabilities	2,000,000,000
Shareholders funds	
Share Capital	140,000,000
Reserves	102,384,450
Shareholders' funds	242,384,450
Total Liabilities and shareholders funds	**2,242,384,450**

Basic Income Statement

	R
Interest Income	158,263,500
Interest Expense	100,000,000
Net Interest Income	**58,263,500**
Premium for Deposit Insurance	20,000,000
Income from Deposits and Investments	**38,263,500**
Non-Interest Income	1,080,000,000
Operating Income	**1,118,263,500**
Operating Expenditure	972,000,000
Net Income before taxation	**146,263,500**
Taxation	43,879,050
Net Income after taxation	**102,384,450**
Return on capital	42.24%
Interest margin	2.6%
Operating Cost to revenue	87%
Deposit base	**2,000,000,000**

Chapter 6

The payment system and competition

This chapter consists of the following sections:

1. An overview of the payment system.
2. Participation in the payment system.
3. Competition in the payment system.

and the following appendices:

1. Flow of payment instructions and their oversight.
2. Co-operative structures.

The findings and conclusions of the analysis are:

- The South African payment system is a regulated responsibility based on safety and soundness; however, the objectives of risk reduction (and through it consumer protection) and maximisation of efficiency and effectiveness are also important.
- In terms of the National Payments System (NPS) Act only banks are allowed to participate in clearing-house activities and keep a settlement account with the Reserve Bank.
- The lack of a tiered banking structure has resulted in a number of non-bank institutions participating in the payment system on a sponsored basis through one of the member banks. While this is an anomaly in terms of the NPS Act, this system is in place in most of the banking systems of the world.
- From a value perspective, most payments are credit payments, whilst from a volume (or number of transactions) perspective, cash is clearly still king. Micro-loans and buy-aid society payments make up a small part of the transactions through the payment system, although they affect millions of customers.
- The big challenge for the payment system is to develop into one that also caters for the previously unbanked sector of society. The payment networks of the major banks and the post office aim to bring 80% of the population within a 20 km radius of an access point into the payment system by 2008.
- The demise of the smaller banks means that by the end of 2003, the Big Four banks accounted for virtually all the throughput of the payments system.
- Establishment of second and third tier banks can deal with many of the competitiveness issues, arising from lack of competition in deposit taking, of the payments system.
- The possible implementation of an e-money directive enabling electronic transmission facilities by suitably regulated institutions requires investigation since such implementation may lessen the dependency on cash for lower income earners and create healthy competition in an environment currently dominated by a government institution.

6.1 AN OVERVIEW OF THE PAYMENTS SYSTEM

The Bank for International Settlements (BIS) indicates that a payment system consists of a set of instruments, banking procedures and, typically, interbank funds transfer systems that ensure the circulation of money. It further describes a payment as the payer's transfer of a monetary claim on a party acceptable to the payee. Typically, such claims take the form of banknotes or deposit balances and/or a credit arrangement held at a banking institution or at a central bank. Such claims, however, may also be held against certain non-banks.

The South African payment system is clearly a national asset, in the sense that:

- It has never failed in the past, and it accordingly generates confidence in the system.
- Its sophisticated infrastructure is internationally comparable.
- Its acceptance by the international financial community is reflected in the fact that South African banks are approved members of the CLS Bank[1] thereby facilitating the Rand as currency to be traded in internationally on the same basis as the Dollar and the Euro. In the future, the Rand will be the 15th currency accepted by CLS Bank.

Figure 6.1.1 provides information on certain items of the South African payment system. Payments within the payment system can be divided in five categories namely cash payments, card payments, cheque payments debit orders and credit payments. The average turnover in payments (excluding cash) for 2003 was R 3.3 trillion per month, which is 3.3 times the 2002 Gross Domestic Product.

Table 6.1.1 depicts the value and volume percentages of each category. In terms of value about 90% of all transactions are credit transactions. They make up only 2% of the volume of all transactions. By contrast cash transactions represent around 2% of the total value of transactions but make up over 90% of the volume.

Membership of payment-clearing houses is limited to banks, mutual banks and/or branches of foreign institutions that also hold a settlement account with the Reserve Bank. These restrictions have been imposed mainly for systemic risk reasons (see Section 6.2.)

Participation by non-banks could require a National Treasury bailout if such a participant posed systemic risk. However, this would only be a possibility if such a participant was involved in deposit-taking on a large scale. Hence, while retail payment systems typically do not pose any immediate threat to systematic stability, a variety of risk reduction measures are used to protect such systems against systemic risk. Fraud, operational and other risks are generally addressed through technical features of various payment instruments and system controls. For instance, emerging payment media, such as internet-based instruments, are exploring the use of such security measures as public key cryptography, digital signature and other technologies. Moreover, payment systems have become more efficient, with important contributing factors having been technology and standardisation.[2]

Currently the big challenge for the regulatory authorities and the banks is to develop a low-cost account to the previously unbanked population (see also Chapters 5 and 7). In this challenge the payment system plays a crucial role.

There are those who are isolated from bank branches or devices through which the payment system may be accessed. Figure 6.1.2 indicates substantial geographical gaps in the provision by first tier banks, and the Task Team acknowledges that there are structural reasons why these gaps are unlikely to be filled by existing banks. However, the potential access to savings envisaged by the enablement of second and third tier banks, and, following investigation, the possible implementation of an e-money directive enabling electronic transmission facilities by suitably regulated institutions could do much to fill these gaps and lessen the dependency on cash for the lower income earners.

Depending on the definition of e-money, which can be restricted to small amounts, defined as pre-paid, carry insurance in the form of a percentage amount held in collateral and not paying interest[3], can limit the regulatory burden for the authorities. Such a definition of e-money has the potential to create reputation risk to the payment system but could facilitate more choice in a currently government dominated part of the payment system.

Table 6.1.1 Volume and Value percentages (2003)

Type	Value percentage
Credit payments	93.25%
Cheque payments	3.46%
Cash payments	2.62%
Debit orders	0.57%
Card payments	0.10%
Type	**Volume percentage**
Cheque payments	1.78%
Credit payments	2.30%
Card payments	2.76%
Debit orders	2.77%
Cash payments	90.38%

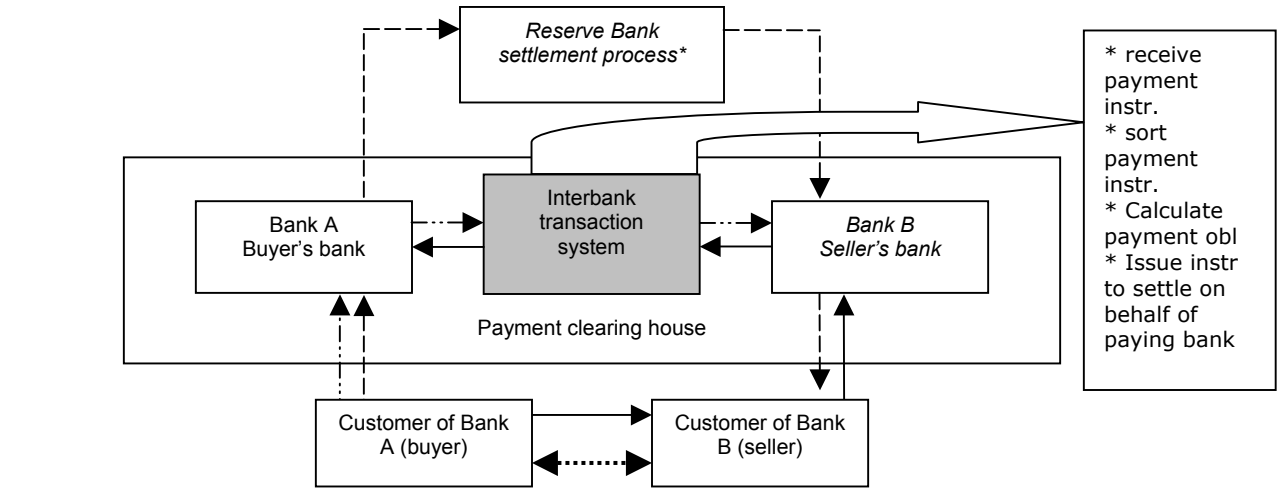
Source: Turnover of Cash = Coin and banknotes in circulation (SARB, 2003) times four for value and divided by R150 for volume. Other volumes and value: Payments Association of South Africa (PASA) (2003) extrapolated to include estimates of on-us transactions.

[1] Continuous Linked Settlement (CLS) is the private sector's answer to the request from the Regulatory Authorities to remove cross currency settlement (Herstadt) risk.

[2] BIS, 2000. Clearing & Settlements Arrangements for retail payments in selected countries.

[3] However, as indicated in Chapter 11, the EU Directive on e-money created a separate prudential regime for non-bank entities that are engaged in the provision of electronic payment services (defining minimum entry requirements, capital requirements and supervisory standards in respect of such entities.)

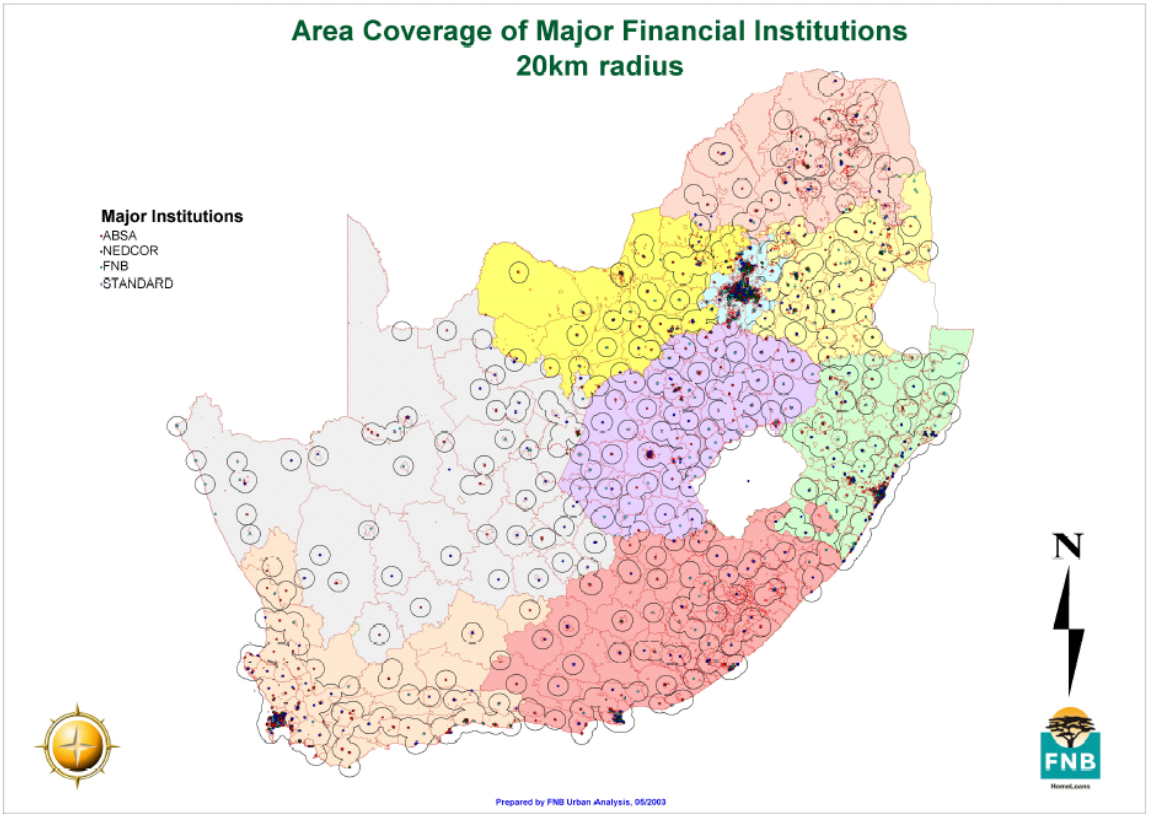
Figure 6.1.1 The South African payment system



Legend:

·····▶ Initial purchase (where buyer & seller uses the same bank, settlement takes place within that bank)	——▶ Dt payment instruction flow
—·—▶ Ct payment instruction flow	– – –▶ Claim (payment) flow

Figure 6.1.2 Area coverage of the Big Four



6.2 PARTICIPATION IN THE PAYMENTS SYSTEM

Broadly speaking, participants in the payment system include not only banks, the interbank transaction system and SAMOS, but also individuals making payments by using instruments such as cash, cards issued by clothing stores or buy aid societies, prepaid cards issued by telephone companies and the internet. (Appendix 6.2 describes this participation in some detail.)

However, operation in clearing and settlement is narrowly regulated. Only those institutions that are regulated by the SA Reserve Bank (i.e. banks, mutual banks, and branches of foreign banks) are eligible to become members of a payment clearing house and keep a settlement account at the SA Reserve Bank[4]. This limitation is required to ensure the stability of the payment system under supervision of the SA Reserve Bank. The instruments, systems and processes of banks operating within payment-clearing houses, form the basis of the interbank transaction system. (See shaded area of Figure 6.1.1, Section 6.1.)

In order to ensure ongoing stability in the payment system, as in other countries and in line with BIS requirements, various risk reduction measures were implemented including the creation of the National Payment System Act, 1998 (NPS Act) (to curb legal risks) and a real time settlement system (South African Multiple Option Settlement or SAMOS system) was implemented.

The NPS Act obliges the Reserve Bank to oversee the payment system from a systemic risk perspective. In addition, the **Reserve bank is required to guard against activities that are or will be contrary to the public interest or to the integrity, effectiveness or security of the payment system**. This obligation differs from banking regulation in the sense that the Reserve Bank, as overseer of the payments system, has a primary obligation to ensure the functioning of the system rather than the individual bank itself.

The South African National Payment System – Framework and Strategy document (November 1995[5]) detailed the strategy for the payment system to 2006, including 13 fundamental principles, one of which is "2.5.9 All banks are eligible to clear payments in their own name." This states "A bank, providing payment services to its customers, should preferably participate in the interbank clearing process under its own name, thereby ensuring that all exposures are visible".

This principle was adopted by the banking industry in conjunction with the SA Reserve Bank in order to allow wider participation from smaller players. During the implementation phase, many of the smaller players opted either to exclude themselves from the clearing system or to negotiate a deal with one of the larger players to sponsor such a player in the payment system.

Obligations of banks that are members of a payment clearing house without a settlement account are settled by another bank under a so-called sponsorship arrangement.

Historical arrangements and the fact that South Africa lacks a multi-tier banking structure, has resulted in a number of non-banks becoming members of the payment system on a sponsored basis. The Postbank, for example is a sponsored financial institution in the payment system. It has no settlement account at the SA Reserve Bank[6]. While this is an anomaly in terms of the NPS Act, this system of sponsorship is in place in most of the banking systems of the world.

Sponsorship can take three forms, namely:

1. Sponsorship of the settlement of obligations that stemmed from clearing.
2. Clearing and settling on behalf of a smaller player by a larger player.
3. Technical sponsorship where the smaller player uses systems of the larger player but clears and settles in its own name.

These relationships are negotiated on an individual basis between the bank requiring such a service and the bank providing it. None of the three possibilities (regardless of precautionary rules) is widely used as banks are wary of allowing information to be gleaned by a competitor in this way.

Table 6.2.1 indicates the number of banks and non-banks active in the payment system. There are some 60 institutions that have at least some access to the payment system, of which 19 are non-banks.

Table 6.2.2 indicates the names of the banks currently active in the interbank transaction system as well as membership of the different payment clearing houses in some detail[7]. It is clear that while each bank is a member of the immediate settlement payment clearing house (PCH) agreement (or SAMOS); only a minority have membership of some of the others.

There are relatively few banks with membership of those PCH's that serve the retail high-volume segment: These include PIN-validated electronic debit payment instrument, (e.g. SASWITCH ATMs), electronic codeline clearing debit payment instrument PCH (for cheque clearing) the paper credit payment instrument (for deposits on an agency basis), as well as the debit card and credit card PCHs. In addition, a handful are members of the STRATE[8] and BESA[9] PCH agreements. Membership of each of these PCH's is predicated on meeting monetary, technical and other requirements. As will be seen in Section 6.3, the Big Four banks dominate the system.

[4] Payment services provided by banks (enabling payers to transfer their claims to a beneficiary at the beneficiary's bank) must not be confused with payment services provided by, for instance, retailers that receive money or payment on behalf of a third person such as a municipality for water and lights.
[5] The document can be viewed on the SARB website: www.resbank.co.za

[6] At present both the Postbank and the Landbank are exempted from the Banks Act - these legal anomalies stem from political pressures in the past.
[7] Saambou (in receivership) & the Reserve Bank are included in the list.
[8] Share Transactions Totally Electronic (for transactions on the JSE Stock Exchange SA.)
[9] Bond exchange of South Africa.

Table 6.2.1. Number of banks and non-banks active in the payment system

Type of institution	Number
Settlement clearing banks	17
Sponsored clearing banks	2
Non clearing banks	22
Bank total	41
Buy-aid societies	7
Chain stores	8
Exempted institutions (including Postbank)	3
Loyalty scheme providers	1
Non-bank total	19
Grand total	**60**

Source: Banks = SARB; exempted institutions = SARB; The rest = various financial journals

Figure 6.2.2 Structure of oversight through the payments system

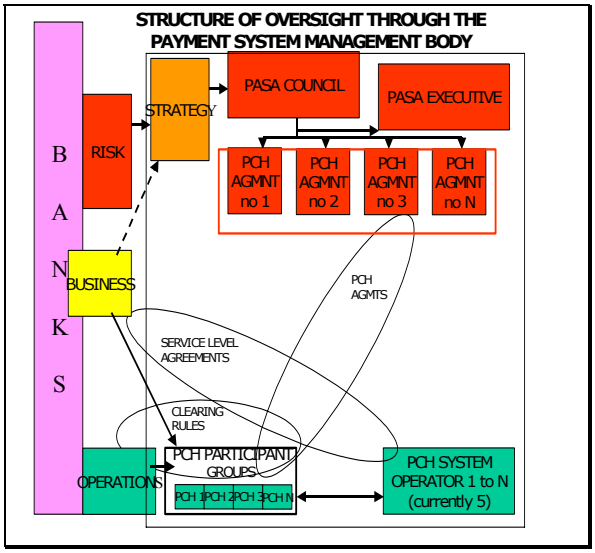


Table 6.2.2 List of PASA banks per Payment Clearing House

	BANK	IMMEDIATE SETTLEMENT (>R5 mil)	ELECTR. CREDIT PAYMNT INSTR. (ZAPS) (<R5mil)	PIN VALIDATED ELECT. DEBIT PAYMENT INSTR.	ELECT. CODELINE CLEARNG DEBIT (Cheques)	PAPER CREDIT PAYMNT INSTR. (Cash)	EFT DEBIT PAYMNT INSTR. (e.g. Debit Orders)	EFT CREDIT PAYMNT INSTR. (e.g. Salary Payment)	STRATE (JSE)	BESA (BOND EXCHANGE of SA)	DEBIT CARD	CREDIT CARD	REAL TIME DEBIT PAYMNT INSTR. (Nupay)	TOTAL
1	ABN Amro Bank NV Johannesburg Branch	1	1				1	1						4
2	ABSA Bank Limited	1	1	1	1	1	1	1	1	1	1	1	1	12
3	Barclays Bank PLC South Africa Branch	1					(1)	(1)						1
4	Capitec Bank Limited	1		1			1	1			1			5
5	Citibank NA South Africa	1	1		1	1	1	1						6
6	Credit Agricole Indosuez S. Africa Branch	1	1											2
7	FirstRand Bank Limited	1	1	1	1	1	1	1	1	1	1	1		11
8	Habib Oversees Bank Limited	1			1	1	1	1						5
9	HBZ Bank Limited	1			1	1	1	1						5
10	Investec Bank Limited	1	1				1	1				1		5
11	Mercantile Bank Limited	1	1	1	1	1	1	1			1	1		9
12	Nedbank Limited	1	1	1	1	1	1	1	1	1	1	1		11
13	Peoples Bank Limited	1		1			1	1			1			5
14	Rennies Bank Limited	1												1
15	**Saambou Bank Limited (In Receivership)**	**1**		**1**			**1**	**1**						**4**
16	Societe Generale Johannesburg Branch	1	1						1					3
17	South African Reserve Bank	1	1		1			1		1				5
18	Standard Chartered Bank	(1)		(1)			(1)	(1)			(1)	(1)		0
19	State Bank of India South Africa Branch	1	1											2
20	Teba Bank Limited	1		1			1	1			1			5
21	The South African Bank of Athens Limited	1	1	(1)	1	1	1	1			1	1		8
22	The Standard Bank of South Africa Limited	1	1	1	1	1	1	1	1	1	1	1	1	12
	Total	**21**	**13**	**9**	**10**	**9**	**15**	**16**	**5**	**5**	**9**	**7**	**2**	**121**

Source: PASA, number in bracket indicates pending application

The Big Four banks (together with Investec) dominate the payment system, as they together account for 89.2% of the value and 97.7% of the volume in the payment system (excluding cash).

This dominance arises from the interlinking of dominance of these banks in the market for deposits[10] in which they play a key role. This dominance has been enhanced through the recent failures within the banking industry. **Without any form of contestability in the custodian process, such a high degree of concentration may give rise to fears of cartel arrangements between these banks.**

Table 6.3.1 shows that the throughput ratio in terms of volumes in the payment system involved more banks in 2000, prior to the demise of the A2 banks. In 2003, the dominance of the Big Four is very marked, accounting for 99.7% of the throughput.

It would require a dedicated research study to determine whether the payment system is indeed operating like a *de facto* cartel, and whether such a cartel arrangement may even be in the national interest, but then subject to oversight by regulatory authorities. A number of economic factors count in favour of the big banks, such as:

- Banks servicing large corporate clients are usually considered **too big to fail**.
- **Economies of scale** are important in the handling of large volumes of payments, and work against new entrants and smaller banks.
- Smaller banks usually do not have the necessary **capital resources** and lack well diversified business portfolios to handle crises in this specific field of business.
- The lack of a **deposit-insurance scheme** in South Africa reinforces the behaviour of the general public to deal with bigger banks (i.e. those that are as perceived too big to fail).

Over the past decade, micro-loan payments have become a political issue in the payment system. However, micro-loan payments, both in value and volume, form only a very small part of the payment system: 1.9% in volume. Within debit orders micro-loan payments are 2% in value and 5.8% in volume. Similarly, the credit cards of buy aid societies are minuscule in the overall payment system and small within cards: i.e. 5.3% in value and 1.1% in volume. Nonetheless, **these accounts affect an estimated 3.1 million consumers and smaller players should be able to face competition from the larger players on a fair basis**.

Most of the competitiveness issues in the payment system can be dealt with by increasing the contestability in the custodian market, through the establishment of second tier banks, the possible implementation of depositor insurance for smaller banks, the implementation of an e-money directive enabling electronic transmission facilities by non-banks and possibly the harmonisation of the capital requirements of foreign branches in line with EU standards.

[10] In terms of the NPS Act, the objective of the payment system management body is that "of organising, managing and regulating the participation of its members in the payment system" some of which have dominance in the custodian market

Table 6.3.1 Throughput ratios of members of the payment system

BANK	2000	BANK	2001	BANK	2002	BANK	2003
	Throughput ratio		Throughput ratio		Throughput ratio		Throughput ratio
1	35.75669%	**1**	27.11359%	**2**	41.96086%	**2**	40.14935%
2	23.60343%	**2**	26.57962%	**1**	28.50439%	**1**	26.69676%
3	21.12583%	**3**	22.51655%	**3**	18.16074%	**3**	19.22356%
4	14.78219%	**4**	16.19761%	**4**	11.06000%	**4**	13.66465%
5	2.63727%	**5**	4.80521%	**SARB**	0.24759%	**SARB**	0.20420%
SARB	0.95564%	**SARB**	0.98244%	**10**	0.02817%	**10**	0.03727%
7	0.41636%	**7**	0.83679%	**11**	0.01609%	**11**	0.01897%
8	0.55546%	**8**	0.69082%	**8**	0.01073%	**8**	0.00376%
9	0.07991%	**9**	0.09617%	**7**	0.01050%	**25**	0.00036%
10	0.02588%	**10**	0.06031%	**16**	0.00034%	**16**	0.00032%
11	0.01547%	**11**	0.05055%	**18**	0.00025%	**9**	0.00026%
12	0.01835%	**12**	0.02571%	**17**	0.00016%	**17**	0.00025%
13	0.01280%	**13**	0.01575%	**9**	0.00008%	**18**	0.00024%
14	0.00746%	**14**	0.00993%	**15**	0.00005%	**20**	0.00005%
15	0.00020%	**15**	0.00951%	**20**	0.00002%	**14**	0.00001%
16	0.00120%	**16**	0.00312%	**25**	0.00001%	**13**	0.00000%
17	0.00339%	**17**	0.00291%	**14**	0.00001%	**26**	0.00000%
18	0.00110%	**18**	0.00127%	**13**	0.00001%	**22**	0.00000%
19	0.00107%	**19**	0.00088%	**26**	0.00000%	**29**	0.00000%
20	0.00000%	**20**	0.00074%	**22**	0.00000%	**28**	0.00000%
21	0.00021%	**21**	0.00033%	**27**	0.00000%	**27**	0.00000%
22	0.00010%	**22**	0.00019%	**5**		**5**	
23	0.00000%	**23**	0.00003%	**6**		**7**	
24	0.00000%	**24**	0.00001%	**12**		**12**	

Source: PASA

APPENDIX 6.1 FLOW OF PAYMENT INSTRUCTIONS AND THEIR OVERSIGHT

The flow of payments through the payment system can be described for debit instruments and credit instruments, as follows:

1. Debit instrument payments such as cash, cheques, debit orders and debit cards

(a) The buyer, a person wanting to buy goods or services, walks into a shop, chooses what he or she wants and discusses payment with the seller (shop owner).

(b) The shop owner evaluates the form of payment presented i.e. cash, cheque, debit order, debit card, etc and its payment risks. The shop owner can refuse certain types of payment. Increasingly, cheques are declined.

(c) Upon reaching agreement with the buyer, the shop owner will release the goods or provide the service indicated in (a) to the buyer.

(d) The shop owner transmits payment instructions to its banker**, normally in the form of a deposit**, with the understanding that, should its banker (collecting banker) not be able to collect the payment, the shop owner's account will be debited with such un-collected payments.

(e) The collecting banker, depending on its arrangements in a PCH agreement with the banker of the buyer (paying banker), will either transmit all relevant payment instructions directly to the paying banker or will transmit all payment instructions to a PCH system operator, which will deliver the relevant payment instructions to the paying banker.

(f) The PCH system operator utilised in this manner will receive payment instructions from collecting bankers, sort all such payment instructions received and deliver it to the applicable paying bankers. Concomitantly with the receiving, sorting and delivering process, the PCH system operator calculates the gross bi-lateral payment obligations that each paying banker owes to each receiving banker, after which a settlement instruction is delivered to the Reserve Bank on behalf of each paying banker to transfer funds from the account of the paying banker to that of the collecting banker to settle the payment obligation.

(g) The Reserve Bank, upon receipt of a settlement instruction, will validate the instruction and if the account of the paying banker funded (i.e. is in credit or collateral is available for a loan), will transfer the funds to the account of the collecting banker. In cases where a settlement instruction, due to an account not being funded, cannot be effected, internal management processes of the Reserve Bank will take the process of settlement to a logical conclusion.

(h) Upon receipt of any payment instruction the paying banker may honour only a client's mandate, which means that the paying bank is only allowed to debit a client's account based on an authentic payment instruction received from such a client[11]. The paying banker will therefore, within the ambit of the PCH agreement and clearing rules, authenticate the payment instruction and (funds or credit prevailing) either makes the payment by debiting the payer's account or decline to make the payment. A decision to make payment is always taken after settlement was effected in the books of the SA Reserve Bank, except in the case of debit cards (due to the real time nature of the system) where the decision is taken before effecting settlement.

(i) The paying banker, when declining to make payment, will follow a process similar to the process described in (d) to (h) in order to claim back on premature settlements.

2. Credit payments done via telephone, stop order[12] or internet.

(a) The buyer, a person wanting to buy goods or services, walks into a shop and chooses whatever he or she wants and then discusses payment with the seller (shop owner).

(b) The shop owner evaluates the form of payment presented i.e. credit payment into its account and furnishes the buyer with the account number and information regarding its (the shop owner's) banker (beneficiary banker).

(c) The shop owner, upon reaching agreement with the buyer, will release the goods or provide the service indicated in (a) to the buyer. This normally only happens after receipt of confirmation from the beneficiary banker that payment has been received from the buyer.

[11] In the debit-order system, payment instructions are received unaccompanied by Personal Identification Number (PIN) or the individual's signature. This means such payments are not authenticated in advance. Should a payer therefore, after payment has been made, declare (in writing) that the payment instruction was not issued by the payer him/herself or by a properly appointed agent of the payer, then the paying banker will refund the amount involved to the payer and recover the money so refunded from the shop owner via the collecting banker. If no such recovery is possible, then the shop owner's banker carries the loss, and ultimately, if recovery from the collecting banker is not possible, the paying banker will carry the loss.

[12] A stop order is held by the paying banker and a credit transfer is initiated based on the stop order to the bank of the beneficiary. A debit order instruction, however, is held by the beneficiary.

(d) The buyer instructs its banker (the paying banker), by internet or telephone, or by signing a stop-order within the branch with the understanding that, should the account number and information provided by the payer regarding the buyer and the beneficiary bank be incorrect, the paying banker or the beneficiary banker cannot be held responsible for effecting an incorrect payment.

(e) The paying banker upon receipt of any payment instruction may honour only a client's mandate which means that the paying bank is only allowed to debit a client's account based on an authentic payment instruction received from its client.[13] The paying banker will therefore, upon the receipt of the payment instruction from its client (or on the due date of the stop order instruction) within the ambit of the PCH agreement and clearing rules, authenticate the payment instruction and (funds or credit prevailing) either make the payment by debiting the payer's account or decline to make the payment. A decision to make payment is taken before settlement is effected in the books of the SA Reserve Bank, except in the case of EFT credits, where the payer transmits the instructions directly to the PCH system operator rather than his banker, who updates the client's account after effecting settlement.

(f) The paying banker, depending on its arrangements in a PCH agreement with the banker of the shop owner (beneficiary banker), will either transmit all relevant payment instructions directly to the beneficiary banker or will deliver all payment instructions to a PCH system operator, which will deliver the relevant payment instructions to the beneficiary banker.

(g) The PCH system operator, when utilised, will receive payment instructions from paying bankers, sort all such payment instructions received and deliver them to the applicable beneficiary bankers. Concomitantly with the receiving, sorting and delivering process, the PCH system operator calculates the gross bi-lateral payment obligations that each paying banker owes to each beneficiary banker, after which a settlement instruction is delivered to the SA Reserve Bank on behalf of each paying banker to transfer funds from the account of the paying banker to that of the beneficiary banker to settle the payment obligation.

(h) The SA Reserve Bank, upon receipt of a settlement instruction, will validate the instruction and if the account of the paying banker is funded, will transfer the funds to the account of the beneficiary banker. In cases where a settlement instruction, due to an account not being funded cannot be effected, internal management processes of the SA Reserve Bank will take the process of settlement to a logical conclusion.

(i) The beneficiary banker, upon receipt of the payment instructions, will credit the account of the shop owner and inform the shop owner of the payment as arranged between the shop owner and its banker (the beneficiary bank). In the case of high value payments that are settled on a payment instruction by payment instruction basis through the books of the SA Reserve Bank, the agreement between the banks is that the account of the shop owner will only be credited after settlement has taken place. In all other cases, the funds are credited to the account of the shop owner upon receipt and before settlement between the paying and beneficiary bank was affected.

The system guarantees account holders, within reason and by arrangement with the account-holding bank, that money will not be lost due to fraud. The same cannot be said for cash transactions. It therefore follows that fee structures of banks have to include a risk premium to cover the guarantee on credit payments.

[13] In the EFT credit order system due to the delivery of the instruction to the PCH system operator, payment instructions are received that are not accompanied by information, such as a Personal Identification Number or the signature on a cheque, that the paying banker can use to authenticate whether the payment instruction was issued by the payer. Should a payer therefore, after payment has been made, declare (in writing) that the payment instruction was not issued by the payer self or by a properly appointed agent of the payer, then the paying banker will refund the amount involved to such payer.

Central banks worldwide have acknowledged the complexity of the diverse area of payment systems and have therefore adopted an approach of supervision. The largest risks were identified and appropriate risk reduction measures such as legal frameworks and real time settlement systems were implemented. Central banks also acknowledged that any payment system is highly complex and to keep such system secure requires complex technical skills. The framework and strategy therefore included a principal that banks individually, and where applicable jointly, are responsible for managing the risks that they introduce into the payment system which directs risk premium to be included in the fee structure for payments.

The framework and strategy in turn led to the provision in the NPS Act for a payment system management body to assist the SA Reserve Bank in its goal of ensuring the integrity, effectiveness and security of the payment system. This means that the banks (through payment system management bodies), within parameters agreed with the SA Reserve Bank, manage the risks within the payments systems at payments level, whilst the SA Reserve Bank focuses on larger risk areas such as the failure of banks to settle with each other and/or behaviour that may, through contagion, affect one or more of the banks in the payment system.

The vast numbers of transactions that flow through the payment system and the fact that banks need to manage their own risks (especially operational risk) lead banks worldwide to own their own infrastructure rather than to outsource it to private companies[14]. This arrangement is associated with stability and confidence in the system. Some South African banks have ventured into outsourcing (especially in the card and internet arena), but experience has been mixed.

The fact that banks have opted over the years to create and own the interbank transaction system (or PCH system operators) is perceived to assist the major banks to curb the growth of smaller players. Regulators around the world are concerned with access to essential infrastructure. For instance, in the Cruickshank Report, recommendations were made to improve access to the payments system. In the EU, members of SWIFT were required to ensure that non-discriminatory admission criteria were put in place (Van Miert, 1998).

However, another view is that the interbank transaction system is open to all banks active in the payment system and smaller players therefore do not need to recreate existing infrastructure should they meet the interoperability requirements.

[14] This is a common, if not universal, trend worldwide.

Chapter 7

Banking services to the unbanked

This chapter consists of the following sections:

1. The definition of the unbanked and the extent of the problem.
2. International approaches to the unbanked.
3. Non-bank alternatives for the unbanked.
4. Financial impact of being unbanked.
5. Barriers to providing for the unbanked.
6. Requirements of a basic banking account.
7. Role of government in the provision of basic banking services.
8. Providers to low-income consumers (Teba Bank).
9. Providers to low-income consumers (African Bank).

There are both private and social benefits to being banked, these include reduction of theft and the real costs (in money and time) of making payments, the ability to build financial buffers in the form of saving, the ability to make transfers and remit taxes, and a reduction in the cultural and financial distance between deprived communities and the rest of the economy. The incidence of the costs of being unbanked are borne by the most vulnerable citizens in society. The chapter explores the banking provision for low-income consumers, some of who are eligible for banking services, but may not make use of them.

The conclusions of the analysis are as follows:

- Roughly half of South African adults do not use financial services and may be seen as financially excluded or unbanked.
- The unbanked will obviously include those whose income makes them ineligible for banking services, but it will also include some whose income qualifies them for such services. Conservatively estimated, 60% of low-income groups and 80% of the lowest income groups are without access to banking services.
- For households, the implications of a lack of access to banking services are severe. It affects the ability of a household to receive government transfers, or to make payments or to accumulate cash surpluses for planned expenses or emergencies. Lack of a vehicle for saving may result in low-income households resorting to very expensive short-term debt.
- The cost of entry-level banking services together with the negative return on low-value savings accounts discourages the use of banking services and undermines wealth creation. Case studies of smaller banks show that it is possible to serve the low-income segment profitably. Although these initiatives remain relatively small scale, the entry of second and third tier banks will hopefully broaden their outreach.
- Broad and affordable access to the payment system is a prerequisite for increasing the scope of bank services, yet barriers to entry remain.
- The user of a basic bank account must be able to deposit cash and cheques and to withdraw cash. He or she must also be able to receive or make payments electronically.
- The creation of basic bank accounts and the removal of barriers to more extensive use of banking services could facilitate increased access to the lower-middle income clients.
- However, this strategy is unlikely to meet the needs of all the unbanked. Those with very low-incomes may still not be profitably served. For this segment, the delivery of a subsidised banking product or a subsidy to a state supported institution (such as Postbank) may be necessary. Membership-based banks (e.g. Third Tier Banks, Village Banks or Co-operatives) could be of most benefit to this segment of the population.
- To provide services to such low-income earners, the Government needs to play both a facilitatory and a regulatory role. Direct involvement and subsidies should be considered only where the market cannot provide necessary services and should not be provided where the lack of outreach is due to high charges and inappropriate products.

7.1 THE DEFINITION OF THE UNBANKED AND THE EXTENT OF THE PROBLEM

The term unbanked generally refers to those with little or no access to financial services. In South Africa around 50 per cent of the population may be counted as unbanked, and hence without access to even one financial service in the broad categories of transmission, saving, credit or insurance (FinScope, 2003).

The unbanked may be divided into those eligible for financial services and those not eligible for financial services. Those whose earnings are in the low middle-income categories are eligible for financial services but may not make use of them. Those who do not qualify for financial services include those without personal resources who are unemployed or informally or sporadically employed.

The proportion of adults with access to transactions, savings, credit and insurance products is shown in Figure 7.1.1. This depicts a grid of provision with one of four financial services at each of the axes. The graduations on each axis represent proportion of adults serviced, with the pale grid in the graph indicating a possible target of 60%. Currently, only 40% have transmission facilities, 38% insurance and 57% credit and 44% saving facilities. This speaks of widespread lack of financial provision.

When analysed by income or LSM (Life Style Measure[1]) as in Figure 7.1.3, it is clear that consumers in higher LSMs with higher incomes are more likely to have bank accounts. (Those in LSM 10 have average monthly incomes of over R21 000 in 2002, compared with the average monthly income of R500 of LSM 1 groups.) Up to LSM 5, the vast majority of individuals are unbanked.

Generally consumers earning more than R1500 and up to R3500 may be seen as eligible for financial services. The ineligible are most likely to fall into LSM 1-3, earning up to R1500 per month. This latter group makes up 31% of the population. Altogether, 65% of the population falls into LSM groups 1-5. Only 15% of those surveyed in the LSM 1-3 groups had access to a savings or transmission account, while 33% of those in LSM 4-5 had. In the aggregate, only 24% of the LSM 1-5 group had access to an entry-level savings account (FinScope 2003). (See Figure 7.1.2).

Given South Africa's high rate of formal unemployment, the unbanked include those who have been employed, but as a consequence of losing their jobs have had their accounts closed. In a recent FinScope survey, it was noted that 14% percent of the population (or around 3.7 million people) had been banked, but are banked no longer. The predominant reason given for not banking among this group relates to job loss or irregular or low income.

For households, the consequence of being without access to financial services is severe. Households deprived of saving facilities are unable to accumulate for life crises and future purchases. Pensioners have to personally collect cash payouts of their entire pensions, which involves travel costs and makes them vulnerable to robbery. To operate a household budget without mainstream financial services is expensive.

Cost comparisons are given in Table 7.1.1 showing the premium paid for being unbanked. **The transfer of money, making a payment and the cost of credit are all substantially higher for an unbanked individual than a banked person.** The premium shown excludes the opportunity cost of the time taken to facilitate these transactions which are higher for the unbanked.

For communities, isolation from financial services can mean that economic activity drains way from the area.

Case Study of an unbanked rural community[2]

The Mbongolwana area in the Ntuli ward, Kwazulu Natal, with over 25000 residents, is an example of a district without a bank or post office. The financial exclusion of the households and the community is economically stultifying.

Lack of access to an ATM, post office, or other cheque-cashing facilities means that the teachers and other civil servants who work in the area are required to travel to Eshowe (some 24 kms away) to cash their cheques. Most of them spend a significant proportion of their income in the town. Pensioners may claim their pensions through the Department of Welfare at a mobile depot which is set up within the area. On pension day a caravan of petty traders follows the pay-out system and offers the pensioners an opportunity to purchase goods and services.

The negative impact of the absence of financial services is illustrated by the fact that over 75% of respondents referred to the absence of banks when asked about problems residents experienced in the Ntuli ward.

There is little ability for civil servants or pensioners to manage cash holdings or the household budget. While very few of those in this area belong to a *stokvel*, contrary to popular opinion that this is a low-level entrée to financial services, it appears that those who are members of a stokvel have access to an account. Those who have no bank accounts are unlikely to participate in a stokvel scheme. The same applies for hire-purchase agreements. This suggests that access to financial services has a stimulatory and empowering effect.

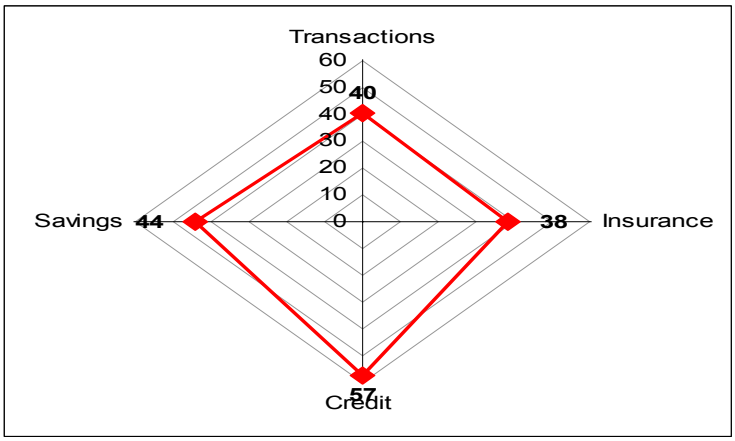
The inability to complete financial transactions within the area has a stultifying effect on the development of the area**.** Those who have access to cash are likely to spend it outside the village, hence reinforcing the lack of supplies of fresh food produce. Given that much of this expenditure takes place on or around payday, there is also little incentive for the village stores to maintain stock throughout the month.

[1] A demographic categorisation based primarily on income category, but includes a number of other consumer patterns associated with different lifestyles.

[2] Demand or support: What counts in rural finance A case-study based on Mbongolwana Kwa Zulu Natal, 2000.

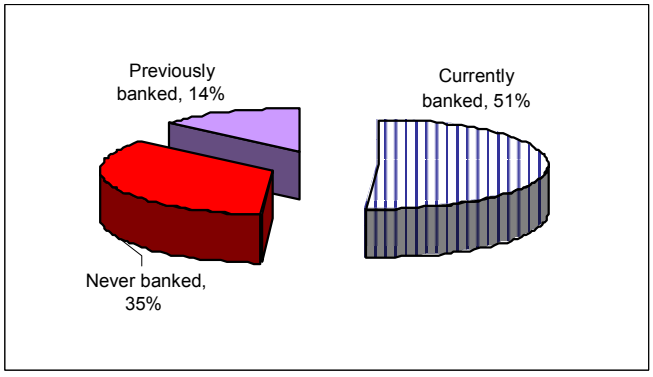
7.1 THE DEFINITION OF THE UNBANKED AND THE EXTENT OF THE PROBLEM

Figure 7.1.1 Percentage of population with access to financial services, 2002



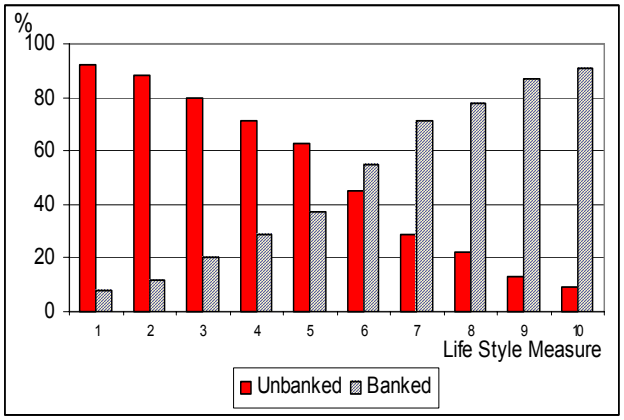
Source: FinMark Trust, 2002 Vision 2010

Figure 7.1.2 Extent of financial exclusion, 2003



"Currently banked" use at least one financial product
Source: FinScope, 2003

Figure 7.1.3 Bank account usage by income category (LSM), 2002



Source: FinMark Trust, 2002 Vision 2010

Table 7.1.1 Cost of being unbanked

As at 17 February 2004	**Unbanked**	**Banked**	
	General Post Office	**Internet**	**Premium for being unbanked**
Cost of a money transfer (Domestic)	R24.5 + 3% value	R2.5+0.5% value	**88.27%**
Assumption: Payment is R250	R 32.00	R 3.75	**R 28.25**
	In person*	**Internet****	
Cost of making a payment	R 20.00	R 5.59	**72.05%**
Assumption: Payment is R250			**R 14.41**
	Informal micro-loan***	**Overdraft**	
Cost of credit - annually	222% - 360%	Prime (11.5%) & Duties	**94%-100%**

* Cost is as for 1 person return trip from outskirts of Potgietersrus into the main town of Potgietersrus

** Daily cost for internet usage - source Mweb (internet monthly service fee R139) and Telkom (cost of a local call at R0.48 per minute).

*** Informal micro-loans generally do not require ID and salary slip, hence formal employment, or regular income

Source: Providers brochures, telephone enquiries

7.2 INTERNATIONAL APPROACHES TO THE UNBANKED

International experience offers the following lessons regarding the unbanked:

- Being financially excluded is associated primarily with unemployment and living in marginalised areas. Poor or non-existent transaction records as well as an inability to show appropriate proof of identity may also block access.
- Lack of access to money transmission facilities is inconvenient and expensive and restricts individuals from participating effectively in the economy.
- The unbanked have little or no access to comparative information on prices and products.
- A switch to electronic government transfers should not place the unbanked at a disadvantage.

Financial exclusion is not limited to developing countries, like South Africa. In the United Kingdom it is estimated that 1.5 million households (around 7%) do not use financial services at all and a further 4.4 million (20%) use just one or two. This latter group may be seen as on the margins of financial services provision. In the United States, some 10 million citizens (around 10%) do not have access to transmission facilities or a current account (Doyle, et al 1998).

This exclusion is a function of both consumers and providers, for which reasons are explored in Table 7.2.2. Customers cite a number of reasons for financial exclusion including high prices, inappropriate design (products having a number of inappropriate conditions attached to them) and inability to manage accounts (financial illiteracy).

In turn, the main reason given by banks for rejection of applications was that the account might become overdrawn. While the technology now exists to prevent an accidental overdraft, financial institutions need an incentive to provide the bundle of services that constitutes a current account to low-income customers. The Cruickshank report suggested that accounts where customers maintain low positive balances and make use of expensive transactions (such as face-to-face transactions for which they are not charged) would require cross-subsidisation. However, provision of even low-balance accounts would be profitable if no interest were paid on positive balances and there were few face-to-face transactions.

From the providers' side, financial exclusion was also linked to lack of appropriate proof of identity to open a current or savings account[3] and lack of a transaction or credit record that might help a potential lender to calculate default risk.

Being unbanked or financially excluded depends mainly on the personal characteristics of the individual, but also on where the person lives.

Research in the UK shows that being unbanked is associated with:

- Lack of a secure job.
- Having parents who do not use financial services.
- Living in marginalised communities. Deprived local authorities, for example, were associated with greater levels of financial exclusion (see Table 7.2.1).

In the UK, around a quarter of those who were currently unbanked had been banked before. Reasons given for no longer using financial services include a drop in income or loss of secure employment or loss of partner (through death or separation) who held all the household's financial products.

The Cruickshank report (2000, p183) identified access to money transmission services (current account or savings account with transmission facilities) as crucial, as these are the gateway to other services. **Lack of access to money transmission services restricts individuals as cash is more expensive than non-cash, more inconvenient and less conducive to managing a household's budget. Access to transmission services through the payment system was seen as crucial.**

The unbanked are also at a disadvantage in terms of access to information about retail services. This has much to do with the lack of marketing to the unbanked. Those excluded are less likely to have access to independent sources of comparative advice and their main source of information on financial services is likely to be the media advertising of financial institutions. These tend to compete on image, rather than on information about products and prices[4].

While there is a trend for government transfers to be paid electronically (which is more efficient), it is important that such decisions do not further exclude those who cannot see the benefits of opening an account. In Table 7.2.3, reasons cited by the unbanked range from the costs and nature of the services (do not have enough money, do not write enough cheques) to an inability to deal with banks (do not like dealing with banks, cannot manage a cheque account).

Alternatives recommended by the Cruickshank report regarding government transfers included:

- Rather than insisting that the individual open the account, the government could open the account, merely as a repository for transfers. The individual could access the transfer through ATM cards or cash-back facilities in retail outlets.
- If the government considered it necessary to intervene in the provision of basic banking services, it should define a universal service and tender for the lowest subsidy required to deliver the defined service.

[3] In particular, money laundering guidelines increase the barriers to opening accounts.

[4] In the US, for example, 30% of low-income families using more expensive check-cashing facilities thought the banks were more expensive (Doyle, et al, 1998).

Table 7.2.1 Characteristics of the unbanked (UK)

Both unbanked and previously banked	Those who have never made use of financial services
Low-income individuals	Householders who have never had a secure job
Claimants of means-tested benefits	Elderly people (aged over 70) who are part of a cash-only generation
Single non-pensioners	Young householders
Minority ethnic groups - particularly Pakistani & Bangladeshi households	Women who became single mothers at an early age
Early school-leavers (before the age of 16)	Minority ethnic groups - particularly Pakistani & Bangladeshi households
Live in rented accommodation	
People living in the most deprived local authorities	

Source: Kempsen and Whyley, 1999

Table 7.2.2 Barriers to banking (UK and US)

United Kingdom	**United States of America**
Consumers' viewpoints	**Consumers' viewpoints**
Banks too intimidating	Banks too intimidating
Inappropriate product design - costs not bundled adequately	Dissatisfaction with bank services
	Information costly or difficult to obtain
Inappropriate delivery of product	Locational convenience, hours of operation
Unable/unwilling to manage their accounts	Unable/unwilling to manage their accounts
Providers' viewpoint	
Unwilling to grant current account: Costs of accidental overdraft too high	
Unwilling to deal with those without a secure job	
Proof of identity to open an account required	
Absence of a credit record is a barrier to credit extension	

Source: Kempsen and Whyley, 1999, Cruickshank, 2000 and Doyle, Lopez and Saidenberg, 1998

Table 7.2.3 Reasons cited by unbanked families for not having a cheque account (US)

Reason	**1989**	**1992**	**1995**
Do not write enough cheques to make it worthwhile	34	30	27
Do not like dealing with banks	15	15	23
Do not have enough money	22	21	21
Minimum balance is too high	8	9	9
Cannot manage or balance a cheque account	5	6	9
Service charges are too high	8	11	8
No bank has convenient hours or location	1	1	1
Other	7	6	3
Rounded Total	100	100	100

Note: Figures are in percentages

Source: Doyle, Lopez and Saidenberg 1998

7.3 NON-BANK ALTERNATIVES FOR THE UNBANKED

Being unbanked is expensive and inconvenient. In this section and the next, the non-bank alternatives and their costs are explored.

The data used here show the use of non-bank alternatives to saving, insurance, transmission and credit facilities by low-income groups (LSM 1-5). While there are non-bank alternatives they are frequently more expensive and their informal nature may compound the vulnerability of the poor.

As regards saving products, the use of bank and non-bank alternatives are shown in Figure 7.3.1. Formal banking products dominate, albeit at a low level[5]. Around 26% of those in LSM 1-5 indicate they have access to a formal savings account. A further 9% indicate stokvel participation (whose funds may or may not be held in a bank account) and 4% indicate they make use of Postbank saving accounts. These latter two may be seen as non-bank alternatives. Missing from this analysis is credit union and village bank membership which do not, however, play an important role in South Africa.

For example, the 32 registered credit unions represented by SACCOL[6], have around 8800 members. While we do not know the income categories of SACCOL membership, if they were all in LSM 1-5, credit union membership would be held by only 0,05% of the low-income population. Credit union penetration remains dismal by international standards (see Figure 7.3.2).

As regards insurance, individuals in LSM 1-5 are more likely to be members of informal and commercial burial societies than formal insurance schemes. Few individuals indicate they are members of pension funds or medical aid funds, for example (see Figure 7.3.3). At 30%, participation in burial societies is by far the most common single product used by the low-income individuals.

In terms of sources of credit for LSM1-5, (see Figure 7.3.4), an individual in the low-income groups is between four and five times more likely to have a store card with rotating finance than a loan through a bank. Access to store cards, usually from clothing and other retailers, appears to be accessible to even the poorest of individuals. Some 6% of LSM 1 Group indicated that they had access to this form of credit. While loans from family or friends are clearly important, there is not widespread use of micro-lending with only 0,6% and 0,8% of those in LSM 1-5 indicating that they make use of formal or informal microloans respectively. The low levels of overdraft use for LSM1-5 corroborates the idea that current accounts are generally restricted to consumers who earn R3 500 and more per month (LSM6 and above), and overdrafts are generally granted only to consumers who earn well above this level.

Those in LSM 1-5 may be able to access credit in the form of microloans from banks and other providers, if they are formally employed. Where consumers are unemployed, informal moneylenders (mashonisa) may be their only provider. Microloans of up to R10 000 for a period of up to 36 months are exempt from the usury cap. Micro-loans, credit instalment sales and store credit are available at a considerably higher cost than overdraft credit, but generally only for those in LSM 4 and above. (See Section 7.4.)

Access to mortgages is also generally restricted to those who earn at least R3500 per month. Less than 0,5% of consumers in LSM1-5 have a mortgage (see Figure 7.3.4). This means that those with lower incomes can only have access to loans for housing above R10 000 if they have pensions to cede as security. While incremental housing loans are provided by the retail financial intermediaries of the National Housing Finance Corporation and the Rural Loan Housing Fund, these come at higher cost than a mortgage loan (see Section 7.4). Access to a mortgage is particularly significant as it implies access to other credit products such as credit cards and allows consumers the flexibility to use the access bond facility when a portion of the mortgage has been repaid.

Analysis of the debt of low-income groups in terms of annual income shows that 78% of LSM 1-3 (with an annual income of less than R15,000) and 68% of LSM 4-5 households (with an income of less than R25,000) have no debt. The StatsSA data in Figure 7.3.5 show that the debt which is held by these two lower income household groups, is retail and furniture store debt rather than bank debt. This has cost implications for poorer households as it locks them into high-interest-rate debt. (See Section 7.4.)

While access to credit may be seen as a privilege and one that requires adequate levels of financial acumen to manage, access to saving and transmission facilities are necessary to allow households to smooth over life crises and build a base for financial security. With only 15% of LSM 1-3 consumers having access to a transmission facility (shown in Figure 7.3.6) the poorest are likely to find transacting and saving difficult, further exacerbating their financial vulnerability.

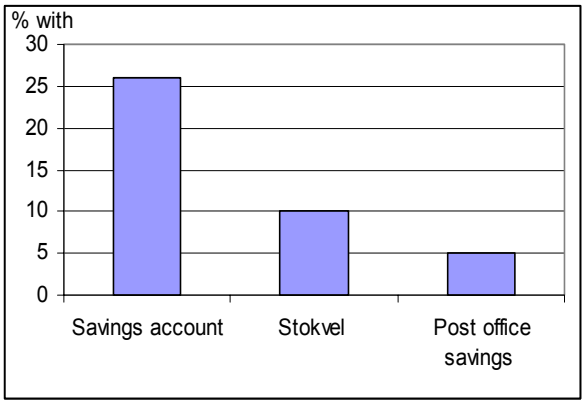
Alternatives to banking transmission facilities in terms of payments include using the Post Office for certain utility payments and for domestic transmission of funds, postal orders.

While it is apparent that there are non-bank alternatives to those who are unbanked, where these alternatives are informal or self-regulated, this may exacerbate the vulnerability of the unbanked. Recently both of the self-regulatory bodies of the village banks, FSA and FINASOL, have failed[7]. Both informal and commercial Burial Societies have poor disclosure to members and mismanagement of funds is a serious problem[8]. Loss of deposits due to fraud implies severe economic hardship by those who can least afford it.

[5] This must at least partly be due to the high fee associated with formal savings products (see Section 7.4).
[6] South African Credit Co-operative League which is the regulatory body of credit unions in South Africa.

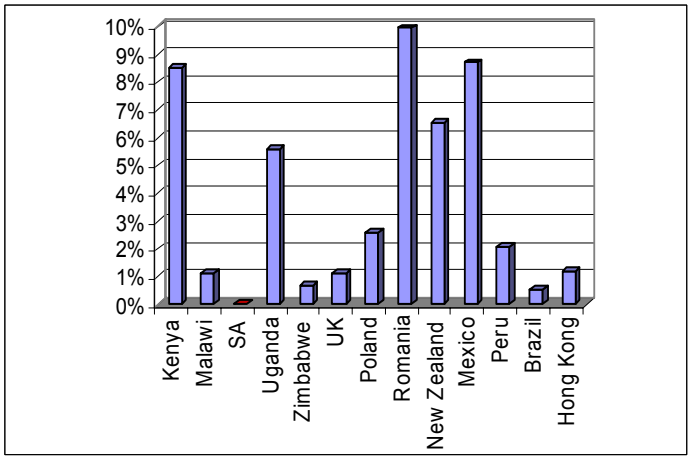
[7] ECI Africa. 2003 p.11.
[8] ECI Africa. 2003 p.7.

Figure 7.3.1 Providers of saving facilities for LSM 1-5 groups: bank and non-bank



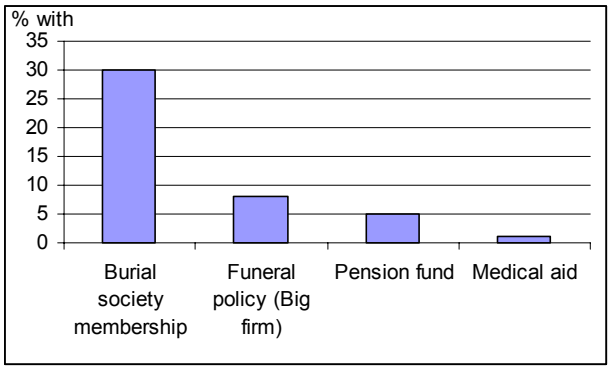
Source: FinScope, 2003

Figure 7.3.2 Penetration of credit unions



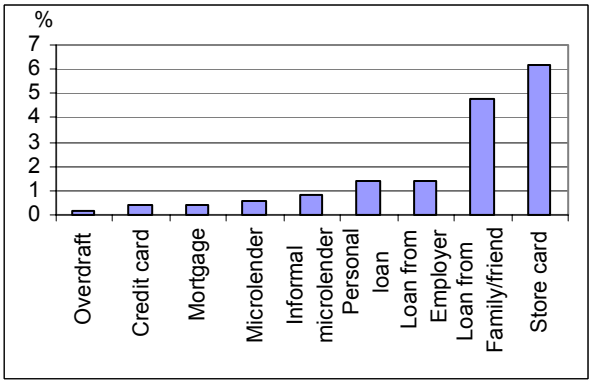
Source: WOCCU website

Figure 7.3.3 Providers of insurance services for LSM 1-5 groups: formal and informal



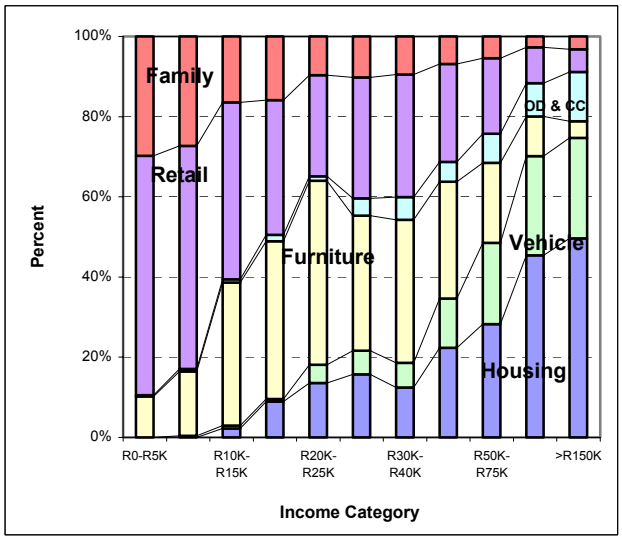
Source: FinScope, 2003

Figure 7.3.4 Source of credit for LSM 1-5 groups: bank and non-bank



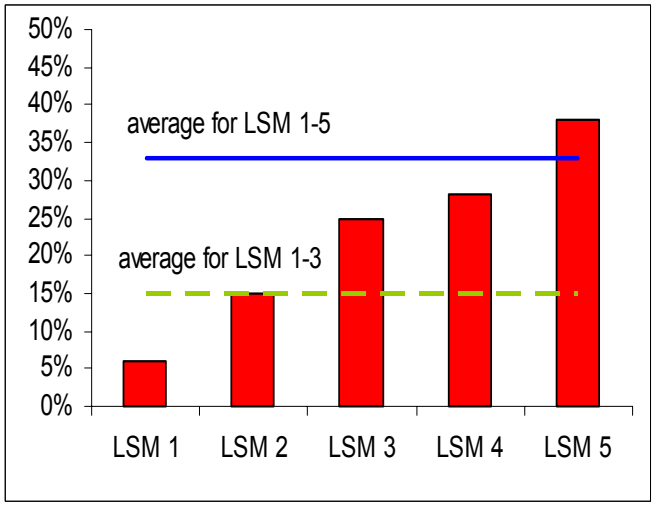
Source: FinScope, 2003

Figure 7.3.5 Categories of household debt by income level



Source: Stats SA data in Daniels 2001

Figure 7.3.6 Access to transmission facilities for LSM 1-5 groups



Source: FinScope, 2003

7.4 FINANCIAL IMPACT OF BEING UNBANKED

In Section 7.3, non-bank alternatives were explored. In this section, the **cost of entry-level bank services and non-bank financial services** are explored:

The analysis here reveals that:

- The fees and charges attracted by entry-level products are a disincentive to low-income users.
- The combination of low interest returns and high fees means that savings can be significantly eroded.
- Those who are unfamiliar with ATM and internet technology pay a premium for over-the-counter transactions.
- The credit available to low-income individuals, such as micro-loans and retail credit, is substantially more expensive than mainstream products.
- The combined effect of the lack of a secure environment where capital is not eroded by high fees together with access to very expensive credit which imposes a heavy debt burden, means that the poor are unlikely to be able to improve their economic circumstances.

In Table 7.4.1 nominal and effective returns on entry level savings accounts are shown. The nominal returns are those offered for savings accounts with small balances, and the effective return is calculated on the basis of the fees charged for making an initial deposit of R500, 11 monthly deposits of R100, 3 withdrawals of R250 and one final withdrawal. If these deposits are made over the counter, then charges of between R28.80 – R118.00 accrue.

The effective returns for the Big Four entry-level savings option (Peoples Bank is owned by Nedcor) range from -12,4% to 19,5%. The fees charged by the smaller banks, Teba and Ithala, are not markedly lower than those of the big banks. (The ability of these small banks to be profitable is highlighted in Section 7.8). The combination of negligible returns on deposits and high fees means that savings in these accounts will be eroded. This makes the effective return negative in all cases, except one. The exception is Capitec, whose business model has been built on micro-loans charged at around 18.5% per month (222% per year). The low fees charged by Pick 'n Pay (a mass retailer) are notable. In partnership with Nedcor, Pick 'n Pay offer some of the lowest transaction charges.

In Table 7.4.2, the total annual cost of different types of consumer credit is shown. The effective cost includes annual fee charges and other add-ons such as credit life insurance. The table shows that mortgage credit is the cheapest form of credit, but that this is usually only available to those in the highest income categories. Other low-cost forms of credit such as high-end leases and overdrafts are also generally only available to higher income groups.

Only pension-backed loans offer relatively low-cost credit to low-income individuals - they offer excellent security for the financial providers and obviously only provide access for those with pensions.

The highest-cost products, micro-loans, low-end installment sales and low-end retail credit, are generally only used by those who have access to few financial services. As consumers move up the income scale, they have better choice and cheaper alternatives.

In Table 7.4.3, an example of some of the costs that accrue to a partially banked individual is shown. The table shows the costs accruing to a pensioner who received a pension in January 2004, paid into an account held with one of the Big Four banks**. The cost of travel, withdrawal and transfer of a proportion of the pension by post office postal order to an unbanked member of the family costs the pensioner over 9% of her income.**

The comparative costs of being unbanked are explored for transmission services in Table 7.4.4. In the table, four scenarios are assumed. In the two unbanked cases, money is received as cash and transferred to family members elsewhere, either using a postal order or the services of a taxi driver traveling in that direction. There are no further costs as the person then carries the remaining cash.

These costs are compared with a partially banked and a banked individual, both of whom receive their salaries electronically. The partially banked individual pays the highest fees, as use is made of over-the-counter withdrawals and a postal order to transfer money. Finally, a person who is familiar with ATM technology is considered. This person receives his or her salary, makes a transfer in the bank's branch and makes two ATM withdrawals during the course of the month.

The table shows that the cost of transmission, in this case a transfer to another family member, is highest for unbanked individuals. While the cost of being unbanked can be enlarged upon, e.g. paying a R32 fee for cashing a cheque, it is acknowledged that it is difficult fully to quantify the costs of being unbanked. However, being banked brings with it certain charges which are high if the individual remains partially banked. This may account for the many individuals who have had a bank account in the past, but have now closed it (or had it closed). The greater the familiarity with technology, the lower the costs for similar transactions.

7.4 FINANCIAL IMPACT OF BEING UNBANKED

Table 7.4.1 Returns on entry level savings accounts

	Interest rate	Fees p.a[1]	Effective Return
ABSA Flexibank	0	R 118.10	**-19.49%**
Capitec	10	R 32.00	**4.04%**
FNB Smart Account	0	R 82.55	**-13.39%**
Peoples' Bank	0.25	R 85.25	**-13.65%**
Post Bank	0.75	R 46.40	**-6.48%**
Standard Bank E-Plan	2.5	R 90.80	**-12.37%**
Theba Bank	0.25	R 50.80	**-8.37%**
Ithala Bank	0.25	R 110.80	**-18.29%**
Pick 'n Pay Go Banking	0.2	R 28.40	**-4.40%**
1= initial deposit of R500, 11 monthly deposits of R100, 3 withdrawals of R250 and one final withdrawal			

Source: Banks brochures

Table 7.4.3 Cost of being partially banked

Pensioner earns state pension per month	**R 700.00**	
(Assume this is her only income)		
Monthly service fee for Flexicard Account		R 2.60
Travel to town to collect funds		R 20.00
Withdrawal of R400 for living expenses		R 5.10
Transfer of R200 to Transkei to family (including:)		R 33.80
* Cost of postal order		
* Envelope		
* Registering the envelope (safety)		
* Postage		
* Transport for recipient to collect from Post Office		
Telephone call to notify recipient of postage		R 1.72
	as % income	
Total charges	**9.03%**	R 63.22

Source: Providers brochures, telephone enquiries

Table 7.4.2 Costs of credit for low-income consumers

High cost ⟷ Low cost

Product	Unregistered Microloans	Formal Microloans	Instalment Sales	Credit cards (inl. Store credit)	Pension backed loans (banks plus pension administrators)	Overdrafts & other loans	Leases and high value instalment sales	High-end Mortgages
Effective Annual rate (TCOC)	360%+	44%-360%	16%-120%	23%-65%	16.5%-18%	18%-23% (or higher different products)	16%-25%	15%-19%
Income group making use of product	LSM 1-3	LSM 1-6; higher rates for LSM 1-3	LSM 1-6; higher rates for LSM 1-4	LSM 1-10; higher rates for LSM 1-5	LSM 5-7	LSM 7-10; LSM 6 min for current a/c	LSM 8-10	LSM 8-10

At a time when Prime is 17% and the Usury Cap is 24% for amounts >R10000 & 26% for amount < R10 000

Source: Feasibility, 2003a

Table 7.4.4 Costs associated with being unbanked or partially banked

Unbanked				**Partially Banked or Banked**			
No bank account		**No bank account - use of Post Office**		**Bank account - branch use**		**Bank account - ATM use**	
Receive cash	R 0.00	Receive cash	R 0.00	Assume salary paid in	R 0.00	Salary paid in	R 0.00
Transfer using services of Taxidriver	R 25.00	Transfer using postal order (excluding travel)	R 17.80	Transfer using postal order (excluding travel)	R 17.80	Transfer (in branch)	R 6.90
				2 Withdrawals in branch	R 34.60	2 ATM "on us" withdrawals	R 8.60
Total	R 25.00	Total	R 17.80	Total	R 52.40	Total	R 15.50

Source: Providers brochures, telephone enquiries

7.5 BARRIERS TO PROVIDING FOR THE UNBANKED

This section explores reasons for the widespread lack of financial provision to low-income groups including:

- Registration requirements.
- Usury cap and other regulatory requirements.
- Barriers to entry.
- Lack of access to essential infrastructure (the South African Payments System).

7.5.1 Registration requirements

Only an entity that is duly authorised by the Registrar of Banks may undertake the business of a bank, namely to canvass for and accept deposits from the general public. In essence, to obtain authorisation, the entity must demonstrate the following:

- The required level of capital, being the higher of either a minimum of R250 million or so much as is determined by the risk weighted assets and market exposures of the entity[9].
- That it has fit and proper shareholders and management who, *inter alia,* have appropriate knowledge, skills and experience to apply sound corporate governance and exercise sound risk management.
- A sound and feasible business plan that addresses a socially desirable need and will make a positive contribution to the economy

The registration structure does not allow for nuanced business models, and explains the lack of variety in the banking industry. For example, in South Africa, there are no building societies. The few co-operatives or village banks are exempt from the Banks Act and hence are self-regulated.

7.5.2 Usury cap and other regulatory requirements

The usury cap undermines pricing of risk and prevents some more responsible lenders from entering certain market segments. In addition, Banks Act provisions limit non-bank providers' access to wholesale funding, which also undermines non-bank competition**.**

Banks have to comply with increasing levels of regulation[10]. This regulation ranges from corporate governance to money laundering and education of clients. At the same time, there are international requirements such as the change in Basel II guidelines and United Nations circulars dealing with identities of known and suspected terrorist operatives. All of these increase costs of operation and may be daunting for a new entrant.

7.5.3 Lack of access to essential infrastructure

One of the barriers to greater participation by new entrants hoping to serve low-income individuals is the payments system[11].

The payments system represents essential infrastructure, allowing participants to access different payment streams. The Payments System of South Africa (PASA) is dominated by the Big Four banks[12], and is subject to mutual governance. Mutual governance systems are problematic for infrastructure where the interests of those in control almost certainly diverge from the interests of the public. In the UK, Cruickshank considered mutual governance of the payments system as anti-competitive.

According to the BIS (2001)[13] a systematically important payment system should have objective and publicly disclosed criteria for participation which permit fair and open access. **Apparently, access for new entrants to the South African payments system, has not been transparent in the past**[14] and interviews with those who have recently attempted to gain access (whether successful or not) reveals that the criteria are not explicitly set out. One successful applicant enlisted the aid of a former member of the National Payments System Department to facilitate their application process. In spite of this the process took close to one year. In contrast the latest entrant took six months.

Box 7.5.1 is compiled from information supplied by those who have recent experience in accessing PASA.

Skills, technology and the financial requirements make entry to the payment system multi-layered and costly. New skills may have to be acquired and retained. The processes required to ensure inter-operability with existing PASA members is cumbersome and time consuming, and testing with PASA and SAMOS (the real-time clearing system of the Reserve Bank) requires careful management. These can tie up key personnel to the detriment of the small organisation.

While information and improved attitudes to facilitate new membership are currently being developed, the process remains cumbersome. Payment Clearing House (PCH) agreements (joint bilateral agreements with each bank) are required for SASWICH, EFT debits and EFT credits.

The technological requirements are also significant, both in terms of initial investment (sometimes in outdated technology, as in the case of EFT magtapes) and in terms of ongoing maintenance and software upgrading.

If a new entrant seeks to gain access to five of the clearing houses, the cost for entry in the first year will be about R1,050 000. This is a substantial cost to a new bank.

These costs notwithstanding, it is the lack of transparency and the mutual governance system which are of most concern to potential applicants.

These themes will be further dealt with in Chapter 8.

[9] While mutual banks have a minimum capital requirement of R50 million, this has not been a successful alternative – with only two mutual banks still registered.
[10] This is an international trend – HSBC international compliance costs for 2003 amounted to some £400 million (Business Day, 2004).
[11] However, a system of technical facilitation can be negotiated with another bank.

[12] The Big Four account for 92,5% of PASA shares (SARB, Policy Sub-Committee No 4, 2002).
[13] The BIS Core Principles for Systemically Important Payment Systems, Clause IX.
[14] The SARB Policy Board (Sub-committee 4) accepted in 2002 that greater transparency was required with reference to participation of banks.

Box 7.5.1 Barriers to entry of new participants into NPS

1. Application process

- Must be a bank (NPS Act, No. 78 of 1998)
- Requires acceptance of all participating banks for each PCH*
- But application process is:
  - Cumbersome
  - Prolonged if submission dates are missed

2. Specialised processes and operational capabilities

- Requires skills and manpower
- Each stream/PCH* has own rules, and permission from each existing banking member of the payments association is required
- New players have low volumes but need reliable technology
- Costly investment in technology to meet requirements
- Certification with other operators is a requirement
  - Necessary to ensure inter-operability
  - Testing of internal processing and procedures is time-consuming
  - 3-Month notice period to other banks needed for live data testing

3. Investment in outdated technology

Some technology is outdated and not readily available (such as EFT magtapes). New entrants must make use of old and outdated technology for some processes.

4. Membership fees (If we assume new entrant wants to be a member of 5 PCHs)

PASA	Share in fixed percentage of costs of PASA budget, plus pro rata charge (based volumes + values) per PCH. (Large banks bear greatest share of cost, but lowest cost per transaction.) **Cost ± R180 000 p.a.**
Payment Clearing House	Fees per application ± R5 000. **5 PCHs R25 000.**
Certification by operator (Bankserv)	Varies from R100 000 – R150 000 **per stream**. (Includes testing plus set up by operator.) **5 PCHs R600 000.**
SAMOS** (SARB)	SMEX software free, but management fee ± **R65 000** per small bank for settlements of each PCH. Hardware for exclusive use – R180 000.

Total estimated start-up cost - R1 050 000.

* Payment Clearing House
** SAMOS = South African Multiple Option Settlement

Source: Interviews and information provided by Capitec, Teba and African bank

7.6 REQUIREMENTS OF A BASIC BANK ACCOUNT

In order to participate in the economy, a consumer is likely to require certain basic banking or lifeline services. Lack of access to money transmission services restricts individuals as:

- Cash transactions can be more expensive than non-cash, as automated bill payments often attract a discount.
- Automated payments offer a means of spreading payments and hence facilitating the management of a limited budget.
- Cashing a personal cheque may be both difficult and expensive without a bank account.
- The ability to use the full range of money transmission services and to gain access to widespread cash distribution systems - particularly ATMs and cash-back facilities - will become more important if individuals are to participate effectively in the economy.

The Cruickshank report (2000: p.184) **suggests that to participate in the economy, a consumer's *minimum requirements* for basic banking services are to be able to:**

- **Receive electronic credits.**
- **Make electronic payments.**
- **Deposit cash or cheques.**
- **Access cash from ATMs or use retail cash-back facilities.**

For many people, there is an additional requirement that they should not stray inadvertently into debt.

These requirements should also be applicable in South Africa, where there is a trend toward electronic or cashless payments. Electronic payments are cheaper, both for supplier and consumer. The use of cash-back facilities is a mechanism which can use retail point-of-sale (POS) facilities to allow cash withdrawal and deposit in remote areas. Since access to a current account is no longer the prerequisite for access to transmission services, the overdraft facility would not be part of basic banking package.

US experience suggests that lifeline facilities need to be cheaper than alternatives, such as cheque-cashing facilities, and that they need to provide ready liquidity and easy payment mechanisms. **Use of cash-back facilities in South Africa at POS would meet the low-income cost and liquidity requirements**.

The requirements for a basic bank account are compared to those of the First Order National Bank Account (FONBA) currently proposed by the Inter-bank Project of South Africa's biggest four banks, possibly in conjunction with the Post Office Bank (see Table 7.6.1). While the features of the FONBA generally comply with the requirements of the basic bank account, it will not allow for electronic payments, which are seen to be part of a higher-order set of requirements and hence excluded at this level. This is somewhat puzzling, given the relative costs of these transactions for consumer and provider alike. Exploiting the existing technology, through cell phones for example, could drive costs down further.

In the FONBA there is a commitment to preserve the savings of lower-income clients, which are currently subject to fee erosion. The facilities of the FONBA will be strictly limited in terms of size and number of transactions. Banks offering the FONBA are quick to point out the need to segment the market and to encourage upward mobility.

This proposed product offering has not been finalised and depends on agreement by the Competition Commission that its price-fixing model does not constitute any transgression of the Competition Act, or if it does so, on application and approval for exemption of the Act. (See Appendix 1.3.)

It is presumed that the cost of this first order account will be lower than the current average costs for entry-level current accounts shown in Table 7.6.2. In each case, the minimum monthly income is shown together with the fees accruing for each transaction. Based on what is seen as typical client usage, if a client just meets the income requirements, over **3% of the client's gross income currently goes into servicing a current account.**

The First Order National Bank Account is part of the commitment of the Financial Sector Charter (2003: 3) to affordability and accessibility to the unbanked. It defines effective access as:

- "Being within a distance of 20 Km's to the nearest service point at which first-order retail financial services can be undertaken, and includes ATM and other origination points….
- "A sufficiently wide range of first-order retail financial products and services to meet first-order market needs and which are aimed at and are appropriate for individuals who fall into the All Media Product Survey (AMPS) categories of LSM 1-5.
- "Non-discriminatory practices.
- **"**A*ppropriate and affordably priced products"* and services for effective take-up by LSM 1-5.
- "Structuring and describing financial products and services in a simple and easy to understand manner".

While the commitments to access have been defined in spatial terms, lack of access is often the outcome of economic criteria (including income and employment) rather than geography.

The Charter (2003: p.9) pledges the provision of first-order retail financial services to 80% of South Africans within LSM 1-5 by 2008. As can be seen in Figure 7.6.1, while there are currently some 2 700 bank branches, and some 6 300 ATMs, an agreement with the Postbank will likely ensure that the 2 700 post office counters will expand the number of conventional financial service points. If such agreements are extended even further, there are around 8 000 social transfer payment points, 8 600 lottery agents (which are used in Brazil for financial services), 104 000 on-line retail merchants and 100 000 spaza shops (FinMark Trust; 2003, p. 7), all of which may be future access points for some or all of the facilities associated with the FONBA.

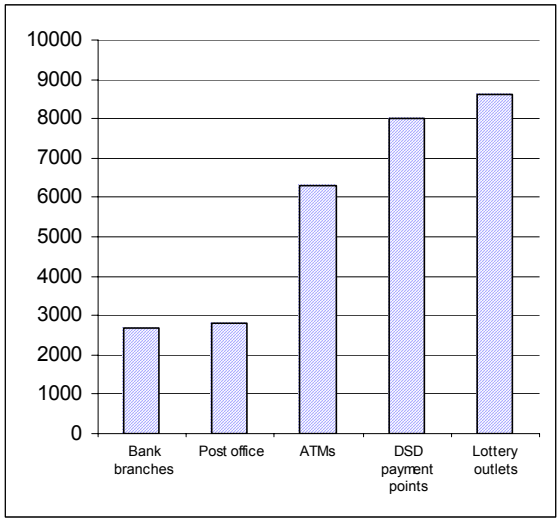
Table 7.6.1 Requirements for a basic bank account

Consumer's basic requirements	Feature of Proposed First Order National Bank Account?
Receive electronic credits	Yes, able to receive salary or grant (limited*)
Make electronic payments	No, not permitted
Deposit cash or cheques	Yes, able to deposit via ATM or counter (limited*)
Get cash from ATMs or use retail cashback facilities	Yes, able to withdraw from ATM (limited). Cash-back feature also possible, although not yet widespread. Dependent on retailer-bank agreements.
Automatic prevention of inadvertent straying into debt	Yes, these facilities will be granted to saving, not current accounts.

* Limited in terms of size and number of transactions

Source: Presentation to FinMark Trust Forum, 11 November 2003

Figure 7.6.1 Present and future delivery points of financial services



Source: FinMark Trust, 2002 Vision 2010 (DSD= Department of Social Development)

Table 7.6.2 Monthly and annual costs for entry level current account

As at Feb 2003		COST TO CLIENT			
Product		**ABSA**	**Standard**	**FNB**	**Nedcor**
Current account	Typical Client profile (No of transactions)	**Silver**	**Classic**	**First**	**Cheque**
Minimum Income per month		R 3,500.00	R 2,000.00	R 3,000.00	R 3,500.00
Monthly Service fee		25.00	30.00	22.50	25.00
Debit orders (Set up cost)	2	12.00	36.00	36.00	36.00
ATM withdrawals--own bank (w/d: R200 each)	2	8.90	8.90	6.50	6.26
ATM withdrawals--SASWITCH (w/d: R200 each)	1	8.10	5.70	8.30	8.08
Electronic payments (R300 each)	2	4.80	8.50	6.00	5.50
Account statement request - own ATM	1	0.00	2.25	1.75	2.75
Account statement request - SASWITCH ATM	1	4.50	6.75	7.75	4.90
Cheques written out (R300 each)	2	12.40	11.50	12.00	20.00
TOTAL MONTHLY COST		**R 75.70**	**R 109.60**	**R 100.80**	**R 108.49**
TOTAL ANNUAL COST		**R 908.40**	**R 1,315.20**	**R 1,209.60**	**R 1,301.88**

Source: Banks' Information Pamphlets

In a regulatory environment conducive to market efficiency, the government's role in provision of services will be required only for those who are marginalised and excluded.

7.7.1 Regulatory provision

Regulation may provide an enabling role for the development of the financial sector, or it may unintentionally protect incumbents through high barriers to entry. In South Africa access to the National Payments System may be an example of the latter. This discussion is expanded in Chapter 8.

The consequences of certain regulations which undermine access to financial services may need to be re-evaluated. The anti-money-laundering legislation currently published in the Financial Intelligence Centre Act (FICA) of 2001 is a case in point. This type of legislation makes it more rather than less difficult for those who do not have a current account to get access should they not have a fixed place of abode.

More flexible requirements for identification need to be considered which may open up the market for technology-based entrants who will be able to make a higher profit from basic banking services. The cost of providing money transmission services is likely to fall since technology offers new entrants the opportunity to provide a range of basic services at lower cost.

The entrance of new competitors may increase the range of choice for consumers who want access to basic banking services and reduce costs as banks compete for this business. Such behaviour may increase the contestability of the low-income market segment.

7.7.2 Facilitatory role

There are several issues concerning government's role in facilitating greater access to banking services:

- As a purchaser of banking services.
- As arbiter of benchmark services and their provision (and the enforcement of the Financial Sector Charter objectives).
- Direct provider of services (through the Postbank).

The lack of universal access to money transmission services imposes unnecessary costs on the providers of services including government, which makes extensive use of money transmission systems to pay benefits. Currently, these services are supplied to a large number of consumers through a book and cash collection at post offices and at social transfer pay points. About 8 000 of these pay points pay 4 million beneficiaries every month, costing between R20-30 per payment per month (FinMark Trust; 2003: 7). This is inefficient. The technology to introduce electronic information systems and a variety of means of delivering cash is now available. **As an arbiter of benchmark services, the government may have a role to play in providing disclosure standards.**

In the UK it was concluded that the lack of information on the provision of basic banking services was a particular problem. To remedy this, and to help speed the delivery of this service, the Cruickshank Report recommended that the government should give top priority to developing a benchmark for basic banking services.

The Cruickshank Report further concluded that it would not be beneficial to consumers if government sought to negotiate with the banks to deliver a "free" service, as it would involve hidden subsidies. However, if government considered it necessary to intervene in the provision of basic banking services, it should define a universal service and tender for the lowest subsidy required to deliver the defined service.

Several recent studies in South Africa (including the Cost, Volumes and Allocation of Consumer Credit Study, FEASibility, 2003) have shown that there is poor disclosure of terms of banking products to consumers**.** The government could establish a benchmark, which would set the terms for banks to follow, and once a bank had met the benchmark requirements, it could advertise this service as compliant.

In South Africa, one model for the provision of basic services is through extending the role of the Postbank. Currently, the Postbank is a state subsidised institution offering saving and (limited) transmission services. The Postbank's operations are reviewed in Box 7.7.

Box 7.7.1 Postbank

The Postbank describes itself as a "savings institution which operates as a division of the South African Post Office", with the mission of being "the preferred provider of quality financial services". This is a role that is currently being further elaborated and defined.

The Postbank's detailed strategy has yet to be fully disclosed and is likely to be advanced by negotiations between government and the financial services sector with regard to the increasing access to banking services as envisaged by the Financial Sector Charter. The agreed strategy is especially likely to incorporate the Postbank in rural areas where the Post Office's distribution network (with 2 700 outlets) is superior to that of most financial institutions. Furthermore, the Postbank recently announced its intention to establish a 3 000-ATM network as part of its attempt to reach some of the estimated 60% of South African adults who do not have bank accounts. The estimated cost of this expansion has been estimated at a minimum of R600 million, if we assume that that ATMs cost R200 000 each. ("Postbank plans ATM's for the masses". Business Day, 31 July 2003.)

While the Postbank contributed to the ailing performance of the SA Post Office in 2002, it has been separated from the Post Office and is currently being incorporated in order to better respond to the basic banking needs of the unbanked. The Postbank focuses on saving products, supporting the needs of 3 million customers. Products include the Flexi Card (a transactions account requiring a minimum balance of R30), Smart Save (a savings account used by 1.8 million customers and requiring a minimum balance of R50) and Maxi Save (a 6-month deposit requiring a minimum deposit of R1 000). The minimum balances and interest rates are set out in Table 7.7.1.

Restructuring is to entail an expanded product range, offering insurance services with, amongst others, its recently announced strategic partner, Thebe Financial Services. A Treasury Division is also being established to manage all financial market operations and associated risks. The planned ATMs are also intended to offer additional services such as the topping-up of cellular airtime.

The bank's Smart Save account costs a maximum of R3,42 a month and is often used by South Africans who are unable to access other financial institutions that demand proof of employment, even in the event of successful informal businesses, such as shebeens, that can entail a high cash turnover. Accordingly, the Postbank has argued for an extension of government subsidy (beyond 2005) on the basis that a third of account holders have balances of less than R50, which cost the Post Office R25 per account, amounting to R300 million. ("Post Office wants state subsidies for savings by the poor". Business Day, 10 July 2003.)

Expansion into micro-credit by a Postbank or other such state institution has no successful international precedents over the long term and such a strategy may undermine private sector competition. In addition, inadequate expertise may lead to rising arrears and excessive costs to the state. Currently, the Postbank operates under an Exemption to the Banks' Act. To the extent that the range of services extended by the Postbank grows, this may need to be revised. While the Postbank has a valuable role to play in providing services to the unbanked, the extent of this role needs further consideration.

Table 7.7.1 Postbank's Products

Product	Nature of product	Minimum Balance	Interest rate on positive balance
Flexi Card	Transactions account	R30	1% p.a
Smart Save	Savings account	R50	0.75% -3.5% p.a.
Maxi Save	Long term Savings	R1000	7.25% p.a.
Group Save	Group Savings	R1500 plus must save R1500 p.m.	3%-7.25% p.a.
Term Save	Term Savings	R1500	3%-7.25% p.a.
Bonus Save	Regular Savings	R100 plus must save R100 p.m.	3%-7.25% p.a.
The products have been geared towards meeting the needs of low-income savers, with the Group saving scheme designed to meet the needs of stokvels, or rotating saving schemes, saving for a particular event or date.			

Source: Postbank brochures

7.8.1 Finance provision to the underbanked

Teba Bank provides an illustration of the potential profitability of finance provision to the unbanked and underbanked, albeit a niche specific institution.

The bank was awarded a non-listed company award in 2003 (*Business Day Survey*, 22 October 2003[1]). This award recognised its expansion plans and existing presence amongst the unbanked and underbanked. Teba Bank plans to target 20% of the underbanked, or nearly 4 million people, situated in rural areas and earning between R450 and R1 800 per month (predominantly LSM1-3). In 2002, Teba Bank recorded a profit increase of 26%, to R53.6m, and a ROE of over 13%, with an existing customer base of 400 000, 70 000 of whom did not have bank accounts previously (*Business Day Survey*, 22 October 2003, see Table 7.8.1). Competitors to its expansion are expected to include Postbank and Capitec.

7.8.2 Teba Bank's operations

Teba Bank describes itself as a "niche bank, aiming to provide affordable micro-financial services to the under-banked in non-metropolitan South Africa". It is owned by not-for-profit trust that is overseen by mining industry employers and employees, represented by the Chamber of Mines and the National Union of Mineworkers, (NUM, Annual report, 2002[15]).

Teba currently offers savings accounts, fixed deposits, microlending, funeral insurance and housing loans, secured by (mostly mining) pensions. This latter arrangement, along with Teba's presence in mining towns and areas and on mines, is key to its success, enabling the bank to capture a niche market that is supported by a number of established relationships with mining pension fund administrators (see Teba Bank's history, below). The Bank (holding R1 billion's worth of deposits) argues that "the community is best served by being a savings-led institution", stressing the need to save before accessing credit.

The bank has accordingly developed a savings account that targets low-income, predominantly un-banked and under-banked rural residents, regardless of employment status.

7.8.3 Teba Bank's history

Teba Bank's origins stem from the mining recruitment agency, Teba, and the Teba Savings Fund, which operated until mid-2000 and provided basic financial services to gold and platinum mineworkers, with over 800 000 savings accounts and 20 million transactions processed annually. Services were provided free of charge to miners and paid by their employers, with Teba initially acting as an extended payroll service and expanding to offer savings account facilities.

During the 1990s, with increased pressure on the Saving Fund's regulatory exemptions (based on a restrictive trust deed) as well as pressure on the mining industry's sustainability, it was decided that Teba should broaden financial services and integrate these with health care and retirement benefits. As a result, the Fund applied for a banking licence in 1998 (which was awarded in 2000) with a revised vision to provide micro-financial services to low-income earners in rural areas. At the same time, Teba was restructured from an employment to a development agency. Teba Ltd and Teba Bank operate as separate legal entities but with an agency agreement whereby Teba Ltd, on behalf of Teba Bank, provides financial services to mining employees, dependants and beneficiaries.

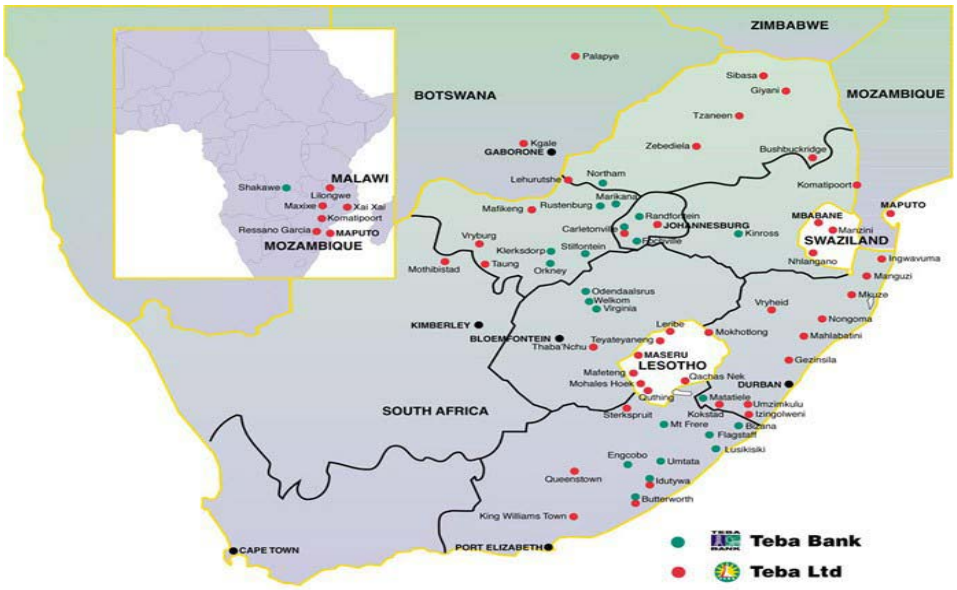
7.8.4 Teba Bank's distribution network

Teba Bank currently has 37 ATMs and 140 branches (80 of which are on mines, 8 in mining towns, 10 in the former Transkei and 45 on Teba Ltd premises). The main Teba outlets are situated in rural Eastern Cape, KwaZulu-Natal, Free State, Northern Province and the North West (see map over page). Teba Bank's distribution network is indicative of its historical links with mining and mining recruitment areas. The overlap also suggests that the bank has grown on the basis of Teba's role and presence in the mining industry and suggests that further expansion (beyond mining communities) is likely to face greater levels of competition.

[15] Downloaded from Teba's website: www.tebabank.co.za

7.8 PROVIDERS TO LOW-INCOME CONSUMERS: TEBA BANK

Figure 7.8.1 Teba Bank: Points of Access



Source: Teba Bank Annual Report, 2002

Table 7.8.1 Teba Bank financial overview

		2002	2001
Return on Equity	%	11.2	26.2
Non-interest income to total income	%	32.3	29.5
Cost to income ratio	%	66.8	45.3
Total Assets	Rm	1 462	1 267
Return on total assets	%	3.0	6.9
Selected Banking Statistics			
Capital Adequacy Ratio	%	67.1	70.3
Risk-weighted assets	Rm	557	399
Return on Risk-weighted assets	%	7.5	21.8
Advances net of provisions	Rm	1 205	1 111
Non-performing advances as a % of advances	%	2.1	1.6
Bad debts as a % of advances	%	2.2	1.4
Provisions as a % of advances	%	2.1	1.6

Source: Teba Bank Annual Report, 2002

ABIL, the holding company of African Bank, describes its mission as "to create choice, opportunity and growth through the provision of credit and related products. We are resolved to bring financial products to the widest section of the population in our country, and to similar emerging markets" (www.africanbank.co.za). While African Bank does not offer saving accounts, they do offer a range of credit products.

African Bank has survived a number of serious challenges to its environment, including the revision of the Persal system and the 2002 A2 banking crisis (associated with the demise of UniFer and Saambou). The bank emerged from the latter crisis with capital adequacy of 34% and cash-generating capabilities in excess of R500 million per annum. The bank tightened its loan approval criteria and shortened the term of its loans in response, manifesting in an improved lending book, and also consolidated by the acquisition of Saambou's personal loan book. Furthermore, in 2002, ABIL concluded a R425 million seven-year IFC facility. Accordingly, CA-Ratings has upgraded the credit ratings of African Bank from a long-term rating of BBB+ to A- and a short-term rating of A2 to A1.

7.9.1 African Bank's distribution network

The bank operates through a distribution network of branded branches, sales offices and mine outlets. The operation is cash-free with disbursements and collections via the inter-bank payments system. This suggests that the market served is more that of underbanked than unbanked. Products are offered at places of employment by roving consultants. Terms for payroll deductions vary from six to 36 months (at an average 29 months), ranging between R1 000 to R20 000 (an average of R10 000) with varying interest rates. Debit-order loans vary from six to 35 months (averaging 18 months), at amounts between R1 000 to R10 000 (averaging R5 500).

ABIL also fully owns Stangen General Insurance, which provides life assurance products to African Bank clients. African Bank has a 47:53 joint venture with Standard Bank to sell African Bank's loan products to Standard Bank's E-plan customers through Standard Bank's branch network.

7.9.2 African Bank's operations

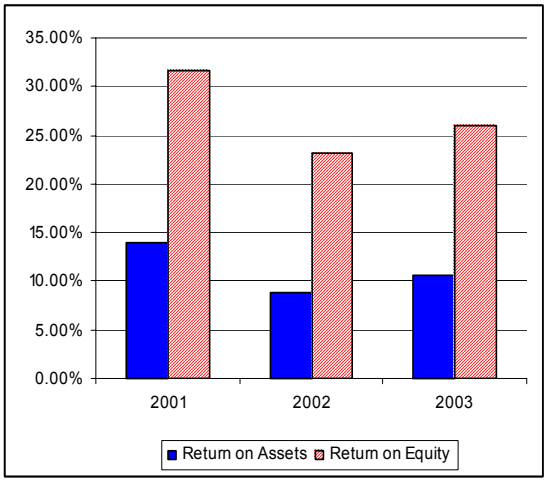
Some selected data for African Bank are shown in Table 7.9.1. Total revenue has increased over each of the past three years, with interest income outgrowing non-interest income, so that non-interest income makes up only 25% of total revenue. The high proportion of interest income is facilitated by the bank's operation within the Micro-Credit Exemption to the Usury Act, which allows the bank to charge more than the stipulated Usury Cap for loans under R10 000. It is this that allows a 49% margin on the advances book.

7.9.3 African Bank's profitability

Despite its niche role in which other credit providers have failed, the profitability of ABIL for the past three years has been sound. The latest year, ending September 2003, resulted in a return on assets of 10.6%, a return on capital of 26% (see Figure 7.9.1), as well as a special dividend per share of 100 cents (over and above the ordinary dividend of 56 cents). This amounts to a Dividend Yield of 5.7. (The Dividend Yields of the big four range from 3.2 to 7.7.)

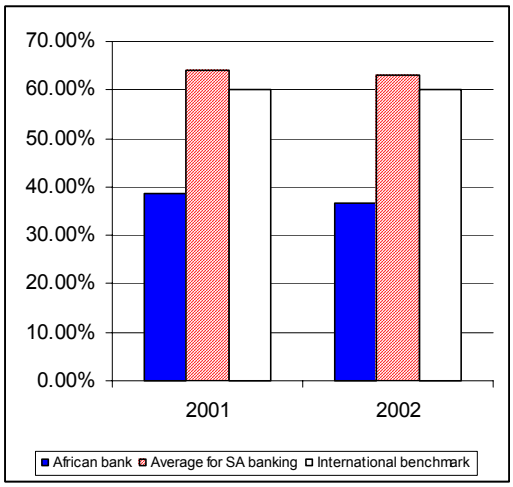
African Bank's level of profitability is in line with other banking institutions. (It is not as high as the returns from the mass-market segments of other banks, although they have not always proved to be sustainable, as the recent example of Nedcor's People's banks has reminded us.) Nonetheless, the results over the past three years suggest that this level of profitability is sustainable, particularly given the African Bank's capital adequacy of 44.5% and the low cost to income ratios of the organisation. At 36.5%, the 2002 (latest available) cost-to-income ratio compares very favourably to that of other South African banks and the international benchmark for efficiency of 60% (shown in Figure 7.9.2.)

Figure 7.9.1 African Bank's profitability



Source: African Bank Annual Reports

Figure 7.9.2 Comparative cost-to-income ratios



Source: African Bank Annual Reports, Bank Supervision Department

Table 7.9.1 African Bank: Selected data

African Bank			
	2003	2002	2001
Items from Income Statement			
Total revenue	R 2,865,730	R 2,564,779	R 2,191,622
Increase in Total revenue	11.7%	17.0%	
Interest income	R 2,295,519	R 2,005,388	R 1,731,875
Non-interest income (including net assurance income)	R 570,211	R 559,391	R 459,747
Non-interest income as a share of total income	24.8%	27.9%	26.5%
Performance ratios			
Margin on advances book		49.0%	48.2%
Return on Assets	10.60%	8.90%	13.90%
Dividend per Share	R 1.56	R 0.30	R 0.25
Return on Equity	25.90%	23.20%	31.60%

Source: African Bank Annual Reports

Chapter 8

Retail offerings to low- and high-income individuals

This chapter consists of the following sections:

1. Features of the retail financial market.
2. Competition and the segmented market.
3. Savings and transmission accounts.
4. Profitable high-end banking case study.
5. Current accounts and credit cards.
6. Mortgages and housing finance.
7. International comparisons and the retail segment.

The international literature suggests that the level of competition in banking has to be analysed by banking service or product, as banks do not compete as firms but compete in the delivery of financial services: being savings, loans and money transmission. The provision of these services is segmented into personal or retail and business accounts. Personal accounts may be further subdivided into low- and high-income offerings.

The unbanked were the focus of Chapter 7. In this chapter we focus on those individuals who qualify for financial services, and distinguish between the offerings and charges for low- and high-income individuals.

The findings and conclusions of the analysis are as follows:

- The retail financial market is segmented according to income and employment status. This results in a market where the substitutability, contestability and level of competition vary for different services, different products and for different consumer groups.
- The Big Four banks dominate retail deposit and transmission services, as well as credit extension to households, with little foreign, niche bank and non-bank competition, except for personal loans.
- Generally, lower-income consumers have access to fewer substitutes at higher prices. There is restricted choice and weak contestability at the lower end of the market.
- Restrictions to entry of low-value payment systems and the low levels of competition between payments systems may be an explanation for the lack of competition in the low-end market segments.
- The case study shows that the high-end retail market is profitable for banks, and can be achieved without membership of cheque and cash payment clearing houses.
- If the threshold of 25% to indicate scale monopoly is applied, then in 2003, ABSA and Standard Bank had scale monopolies in the credit card market, Standard Bank had a scale monopoly in the current account market, ABSA in the mortgage market and FNB in the leasing and instalment sales product segment.
- There are few non-bank mortgage providers and the bank mortgage book is heavily skewed towards the high-end mortgages, implying that the majority of South Africans do not have access to mortgages and the wherewithal to acquire property or to enhance the value of the property they already own.
- International comparisons reveal that South African banks charge fees on more transactions than banks in other countries, and in general, charge higher fees. While there is an international trend towards cost recovery from fees, competition is key to ensuring that fees accurately reflect costs.
- Regulatory changes will be a key determinant of the extent to which the retail market will become more competitive, whether in terms of accommodation of new entrants (e.g. 2nd tier banks), accommodation of new distribution channels, improving the access of new entrants and small banks to the national payment system or improving disclosure of the cost of banking services.

Banking products sold to personal consumers offer at least one of three economic services: money transmission, savings and credit. Invariably, products provide a combination of these services (for example, a current account potentially offers all three).

Retail banking products may be divided into four major product groups:

- *Savings accounts and investment products,* which sometimes have (limited) transmission facilities.
- *Current accounts and credit cards*, which provide access to *money transmission*[1], but also act as savings vehicles and an access to credit.
- Credit, including *personal loans and asset-based finance* (such as for vehicles), which may be both unsecured or secured.
- Mortgage finance, which is the most common form of *secured lending*. In some cases, a mortgage can be used as a substitute for unsecured lending; the reverse is not generally the case. (The price of unsecured lending means it would be an uneconomic way of buying property, or of making major investments in a home.)

Given this division of products, there are a few features of the retail market which influence competition, including the segmentation of the market; the dominance of the Big Four banks; and the Usury Act and its exemptions.

8.1.1 The segmentation of the market

The substitutability, contestability and level of competition vary for the different services, for different products and for different consumer groups.

As was noted in Chapter 7, the retail market is segmented in terms of clients' income and employment status, and these criteria serve as rules of thumb that govern access to substitutes and alternative providers. In Table 8.1.1, an outline of the returns and interest charges facing low-income consumers on the one hand and middle and high-income consumers on the other, is shown.

The returns on low-income deposits are lower, and the rates charged for loans are higher, for low-income consumers. The exception is when loans are secured by collateral, as in the case of pension-backed loans (which are predominantly used by low-income consumers for housing finance). These can be obtained at close to the prime rate of interest.

While the market segmentation will be further discussed throughout the chapter, it is apparent that there are fewer choices available to the lower income groups, and those which are available tend to be at higher cost.

8.1.2. The dominance of the major banks

The four major banks dominate retail banking services in terms of both deposits and credit services. Some 80% of total deposits are the liability of the Big Four banks (June 2003), they account for the bulk of the credit extended to households: over 90% in the case of current accounts, credit cards and mortgages. The dominance in deposits has increased recently, largely as an outcome of the public switching of deposits from other banks to the Big Four towards the end of 2002, as well as the take-over of BOE by Nedcor. This is depicted in Graph 8.1.1. While other banks (i.e. excluding the Big Four and Investec) were responsible for around 25% of deposits in June of 2002, by January 2003, this had declined to only 13%[2].

The dominance of a few banks does not necessarily preclude competition, as there may be high levels of substitutability with other non-bank services[3]. However, in South Africa, there is less non-bank competition than in other countries which implies a relatively sparse matrix of provision, with little diversity of suppliers in these products. By virtue of regulation, savings and transmission facilities can generally only be obtained from banks, but there are more competitors in the provision of credit products. A matrix of provision is shown in Figure 8.1.1. It shows a greater non-bank provision in credit products; however, it is apparent that foreign investment and niche merchant banks have remained out of retail banking.

8.1.3. The role of the Usury Act and its exemption

The Usury Act, with its legislated lending-rate ceiling, aims to protect consumers by setting the maximum permissible interest rate. The usury cap governs the interest rate charged by providers of consumer credit, up to the value of R500 000 except for loans falling under the exemption (less than R10 000 and less than 36 months). In many market segments, however, providers use the cap as if it were a prescribed rate. In spite of the usury cap, the cost of credit (which includes application fees, transaction fees and insurance costs, as well as stated interest charges) *exceeds the usury cap in most market segments.*

There is evidence to suggest that the usury cap has contributed to under-provision of formal financial products to low-income consumers, with gaps in the provision of certain categories of credit. This shortage restricts the choice of product and supplier and leaves low-income consumers locked into small loans at exorbitant cost.

The causes of and implications of these features will be examined in the sections that follow.

[1] The credit card provides limited money transmission, effectively restricted to retail transactions, but for our purposes here they are grouped, as banks issue the vast majority of these.

[2] These data represent total deposits by government and corporate as well as retail deposits.

[3] Wallis, 1997.

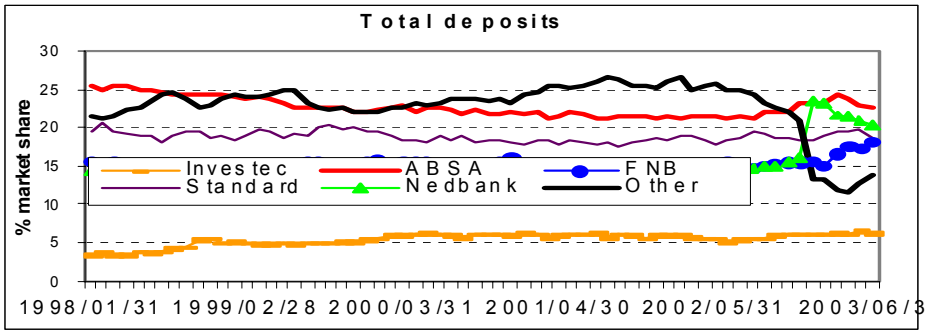
Table 8.1.1 Segmented access to retail financial products

Bankable Consumers							
	Low-Income		Middle - High income				
	LSM4	**LSM5**	**LSM6**	**LSM7**	**LSM8**	**LSM9**	**LSM10**
Monthly income range	R1534	R2195	R3575	R5504	R7427	R10561	R21591
Savings & transmission products	Mass market savings accounts from big and small banks, Burial societies, Post Office		Range of products from banks: savings accounts, current accounts, call accounts; Investment products from non-banks, mutual trusts, etc				
Current average interest payable	0% to Prime less 10% (0% - 1.5%)		Prime less 4% or 5% (6%-7%)				
Housing finance and Mortgages	Pension backed loans and low-end mortgages		Middle and high-end mortgages from Banks, SA Home Loans				
Average interest rate	Prime plus 1% - 3% (12.5% - 14.5%)		Prime plus 1 or 2% - Prime less 1 or 2% (12.5% - 13.5% to 9.5% - 10.5%)				
Private cards and credit cards	Store cards - low clothing retail		Credit cards, Private Label Credit Cards, Store cards				
Costs	Usury rate to 2.5 times the Usury rate (22 % - 56%)		3% below Usury rate to 2 times Usury rate (19% - 45%)				
Leases	No providers		Banks and their agents, retailers of vehicles, etc				
Costs			Prime less 1% or 2% to just under Usury cap (9.5% - 10.5% to 22%)				

Interest rates in brackets use prime of 11.5% as at 10/03/04 Usury rate of 22% (for amounts >R10 000) applies

Source: FEASibility, 2003a. Rates updated to 2004

Graph 8.1.1 Total deposits by bank



Source: Bank Supervision Department

Figure 8.1.1 Competition map of traditional banking products

	Home Loan	Retail transactions a/cs	Personal loans	Credit cards	Bill Payments	Deposit/ Investment Accounts
High street banks	■	■	■	■	■	■
Foreign banks			■	□	■	■
Investment banks						■
Merchant banks						■
Insurance providers						■
Retailers		□	■	■		
Microlenders			■			
Other	■					

■ Currently provide

□ Possible future provider

Source: Bank Supervision Department

There are several possible causes of the segmentation of the retail market into what appears to be a contested high-end segment and a poorly serviced lower-income segment.

In this section, lack of competition and weak market incentives are explored as causes for the segmentation.

8.2.1. Lack of effective competition at the low end

In each of the product types distinguished in this chapter, there is a relative lack of choice in terms of the product variations and suppliers at the low end of the market. The data shown in Tables 8.2.1 and 8.2.2 show for example, the relatively large number of options available to an individual who has R100 000 to deposit, compared those for an individual who earns R3 000 p.m. and has discretionary savings of R100 per month. While there are more banking products available for the wealthier individual there are also more non-bank products. The lack of effective choice restricts competition at the lower end.

Existing bank regulations underpin the lack of competition at the lower end. With high entry requirements and only a single form of bank registration, there is little incentive for innovators to enter the market. Without regulatory change to allow second- and third-tier banks, the status quo is likely to persist.

8.2.2 Weak market incentives at the low end

While weak competition at the lower end of the market could result from poor market incentives, there are a number of possible counter-arguments discussed below.

First, the mass-market segment appears to be profitable: return on equity of the lower-income segment may exceed that of the retail segment taken as a whole. While data for both ABSA's Flexibank and Nedcor's Peoples Bank are shown in Table 8.2.2, the latter have been restated as part of the restatement of Nedcor's 2002 results. The original data are shown in brackets. The returns for ABSA's Flexibank are three times that of the retail segment and Nedcor's Peoples higher than that of the results published for the mainstream retail accounts. In both cases, the cost-to-income ratio of the mass-market segment is much less than that of the retail segment as a whole. The high levels of profitability at the lower end may reflect the low levels of competition in this market segment[4].

Second, the high fees that the segment attracts, suggest that lower-income consumers are willing and able to pay for these services. For some financial services at least, there is an inelastic demand.

This suggests that there may be additional reasons for the apparent lack of contestability in the low-income segment.

One possibility is that in the low-income market, which is characterised by high-volume, low-value transactions, membership of the national payment system is essential. This has been confirmed by Capitec in interview. By contrast, access to payment clearing houses or payment schemes of the payment system is less important for a bank like Investec, whose client base means that it has relatively few, high-value transactions.

With high barriers to the payments system (described in more detail in Chapter 5, 6 and 7), the high costs associated with such access and conditions of access that are biased against small players, competition for the low-income market segment is severely restricted. Given this and their current infrastructure, the bigger banks may have little incentive to extend their product offerings to the low-income market segment. Simultaneously, the conditions for small banks to gain access to the payment system, and the cost of such access, severely hamper their ability to provide financial services to this market segment.

The Cruickshank Report (2000, p. 66 ff) identified a number of concerns regarding the access to the payments system, including:

- The system of mutual governance, whereby the shareholding of payment systems reflects the throughput or use of the scheme,
- The payment schemes, which are run in the interests of those who own them,
- The weak competition between payment systems, and
- Features of mutual governance systems such as the anticompetitive restrictions on access, inefficient wholesale pricing and poor transparency undermine competition.

The Cruickshank Report concluded that while restricted access may be justified in the case of high-value payment schemes, the justification for restriction in low-value payment schemes is much weaker and the economic impact much stronger. The credit and operational risks are no greater than for other areas of commerce, and a requirement that members must be regulated does not of itself reduce the risk (although banks are "backed" by the central bank).

Given these arguments and the apparent dominance of the payments systems by the Big Four banks (seen in Chapter 6), it could well be that restrictions of entry to low-value payment systems and the low levels of competition between payments systems in South Africa (given the consistent dominant shareholding of the big banks) may be an explanation for why the big banks dominate the low-end market segments.

[4] In its 2003 results, Standard Bank, which does not distinguish between upper and lower retail segments, reported a 30% return on equity in the retail segment.

Table 8.2.1 Segmented market: Savings and investment accounts

Bankable Market		
	Low income	**High Income**
Life Style Band	**LSM 4-5**	**LSM 10**
Average Monthly income	**R1,534-R2,195**	**R 21,591**
Saving Products	Mass-market banking services from Big Four Capitec's new saving facilities, Regional banks Postbank Low end endowment policies Burial Societies; Stokvels	Personal banking services from Big banks Call accounts and other from niche and foreign banks Money market deposits; unit trusts Insurance and other endowments Equities and other investments
Interest rate on balances	**0%-10% p.a (Mean 0.25%)**	**3.3%-10.5% (Mean 7.2%)**
Number of providers	9 Commercial banks (those with low-end retail facilities); 1 Postbank Activity in unit trusts likely to be as members of large pension funds Major insurance companies (with low-end retail products) Large number of burial societies and stokvels - although membership usually restricted to regular income earners. Activity on equities market only as members of large pension funds	28 Commercial banks 369 Domestic Unit Trusts; 259 bonds Major insurance companies 472 Listed companies on JSE

Source: Bank Supervision Department, JSE Handbook, 2003

Table 8.2.2 Returns on retail and mass market segments, 2002

Bank segment	ABSA Retail	ABSA Flexibank	Nedcor Retail	Nedcor Peoples
Return on Average Equity	46.6%	151.8%	8% (11.1%)	11% (26.9%)
Cost-to-income ratio	83.4%	65.2%	76.6%	51.1%

Brackets indicate original results; these have been restated in the 2003 financial statements

Source: ABSA and Nedcor Annual Reports, 2003

8.3 SAVINGS AND TRANSMISSION ACCOUNTS

The analysis of savings and transmission accounts will examine:

- The concentration of deposits with the Big Four.
- Access to savings accounts.
- The poor returns to low-value savings accounts.
- High fees on low-value bank and non-bank saving and investment products.

Bank entry requirements do not accommodate 2nd or 3rd tier banks; in particular there are significant barriers to access to the payment system, with the result that the provision of these services is dominated by the top four banks. As of June 2003, the biggest five banks accounted for 86% of all deposits (of which the Big Four made up 80%). This represents a substantial increase from earlier levels. During the period 2000-2001, the level of deposits with the Big Four dipped below 68%. The increase to 80% was associated with the demise of some of the smaller banks and the take-over of BOE by Nedcor. The demise of the smaller banks has undermined choice for both high-income and low-income individuals alike.

While there are no publicly available data on market share of saving accounts, given the substantial dominance of the Big Four in terms of volume of deposits, the vast number of accounts is likely to be held with these banks.

The market for retail deposits in South Africa appears to be far more concentrated than in other countries. One of the reasons for this is the sparse supplier matrix. In the UK and Australia, for example, the Big Four account for only 19% of savings accounts, with other building societies and other banks making up the rest (Cruickshank, 2000: p.120). In Australia, there is wide provision of saving facilities from building societies, life companies and credit unions. The rigidity of the banking registration requirements contributes to the high concentration of retail deposits in South Africa.

The distribution of access to savings and transmission accounts is shown in Figure 8.3.1. It is clear that up to LSM 5, a minority of the population have access to savings-transaction accounts. On average over half of the higher income groups tend to have accounts (although this tapers off for the highest income group, probably indicating access to better substitute products). In all, an estimated 38% of the population have access to a savings-transaction account, while only 4% have a fixed deposit account.

This lack of access to both saving and transmission accounts may account, in part, for the low savings ratios in South Africa. Average savings balances in South Africa are low with a declining trend. The national household savings rate (as a proportion of disposable income) has declined from 2.6% to 0.4% between 1990 and 2002. Other reasons for the low savings rate include broader economic conditions, including high rates of unemployment. Poor returns to saving accounts with low balances and a 'credit culture' also play a role.

The poor return to low-income savings may reflect the lack of competition at the low-end of the market. At the high end of the market there are other non-bank investments, such as mutual trusts, insurance policies and other investments which are possible substitutes. In Figure 8.3.2, the returns on fixed deposit accounts and entry-level saving accounts are compared. The substantially higher return on the latter reflects greater contestability at the higher end.

The consequence of generally low-interest rates on low-value positive balances, together with a plethora of transaction fees, means that the return on savings (even disregarding inflation) is likely to be negative. South African banks tend to charge for most transactions, including making deposits over the counter and making withdrawals. In graph 8.3.1, the fees for cash deposits of R600 are shown for the top four banks. The charge averages around 1% of the value of the deposit. Charging for making deposits is a feature of the South African banking industry that is not shared universally. For example, in 2003, a comparison of fees with 18 other European, Australasian and North American banks revealed that only one international bank charged a fee for deposits (Infochoice, 2003). This is further explored in Section 8.7.

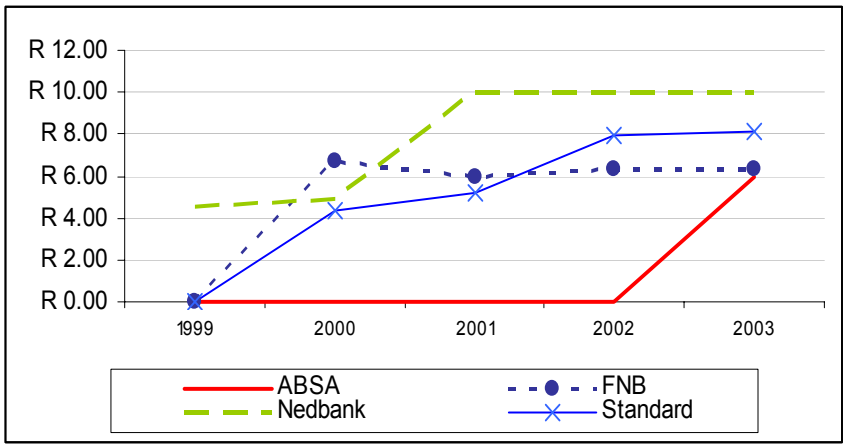
While it is difficult to compare the returns on different savings and investment products, given that the comparison can often only be made after the fact in the case of many investment products, the fees accruing to different savings/investment products for high and low values have been explored. These data are shown in Table 8.3.1. In the low-income case, it is assumed that R200 per month is saved over a period of five years. The fees from the unit trust and endowment are charged up front, but the savings account fees accrue monthly (an annual escalation of 5% has been assumed). In the case of the high-value accounts, R5000 per month is invested. It is apparent that apart from the unit trusts, the fees accruing to the low-end saving products are higher. Coupled with the generally lower returns to low-value saving/investment products, this doubly disadvantages lower-income consumers.

Table 8.3.1 Segmented market: Examples of Low- and High-end savings options

Low end savings			High end savings		
Institution	**Product**	**Fees as % of money invested**	**Institution**	**Product**	**Fees as % of money invested**
Standard Bank	E-Plan (savings plan)	3 %	Standard Bank	Money Market Fund	1%
Stanlib	Wealthbuilder Fund (General unit trust)	7%	Stanlib	Prosper Fund (General unit trust)	7%
Momentum	Endowment	19%	Momentum	Endowment	14%

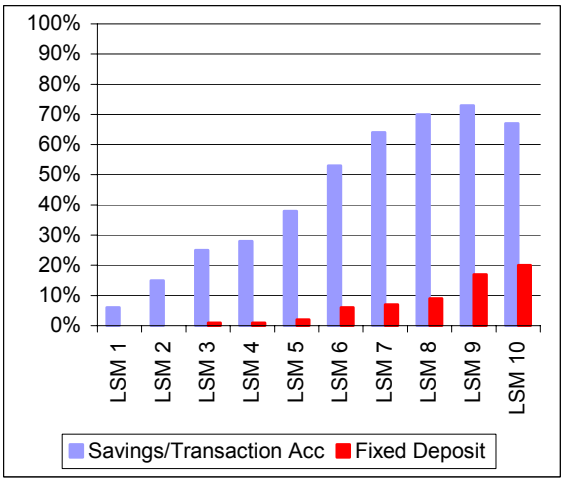
Source: Bank brochures, telephone enquiries

Graph 8.3.1 Charges for over-the-counter deposits: R600



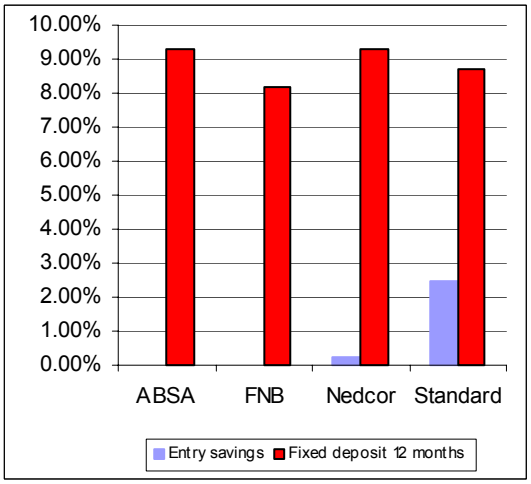
Source: Infochoice

Figure 8.3.1 Per cent of population with a savings and fixed deposit account



Source: FinScope 2003

Figure 8.3.2 Interest on positive balance: entry savings and fixed deposit > R10 000



Source: Bank brochures

Investec - a profitable upper-end banking venture

8.4.1. Background

Investec's private banking activities were initiated to support Private Client Activities (specifically, portfolio management and stock broking) and have proved to be particularly successful, with a focus on active, wealthy entrepreneurs that the group believes have been neglected. In some instances, the group has taken equity stakes in businesses of private clients.

Investec clients are typified by the following profiles:

- High-income professionals who are members of a recognised professional body, such as the South African Institute of Chartered Accountants, with income calculated as net annual earnings in excess of R500 000. (Trainee Chartered Accountants, Chartered Accountants and Specialist Medical Practitioners are not expected to meet the minimum earnings criteria.)
- High-income salaried individuals earning in excess of R550 000 annually.
- High-net-worth individuals with investable assets in excess of R5 million (aside from homes and personal effects).
- Established entrepreneurs with a successful track record, net profit after tax of more than R2 million a year and a minimum asset portfolio of R10 million.

According to Investec's 2003 Annual Report, the success of the group's strategy is founded on an "integrated approach to wealth creation and wealth management", targeting "high income and high net worth individuals". Peers have consistently rated Investec as the best private bank in South Africa in the Price Waterhouse Coopers (PWC) annual Banking Review.

Operating profit before amortisation of goodwill for private banking increased by 54.7% to £21.8 million, (R285 million) with Private Client Activities representing Investec's most successful business, accounting for 25.1% of the group's income (Interim Report, ending 30 September 2003).

Lending to private clients in South Africa grew strongly over the year, by 15.1% (to R19.8 billion), and despite lower interest rates, profitability increased. (The group's UK and Australian private banking operations gave good yields.) Growth in net fees and commissions was significant. The growth is attributable to increased lending turnover, advisory fees and transactional banking fees, which now make up 43% of total income (see Table 8.4.1).

8.4.2. Savings options

A number of banks have started to enter the ambit of private banking (including FirstRand, and Nedcor, via BOE). The wide and competitive range of savings rates offered to high-income consumers suggests greater levels of contestability within this market segment than in others. This inference is supported by the greater range of profitability ratings given to private banking by banks surveyed in the 2003 PWC Banking Review, as compared to the retail sector overall. (Seven of the eleven respondents to the private banking profitability questionnaire rated it as 'profitable' to 'extremely profitable'.)

Investec's range of product offerings for savers is detailed in Table 8.4.2. It is significant to note that some of Investec's offers apply only to older clients and most tend to require minimum deposits of R100 000, an amount beyond the means of almost all South Africans. The competitive lending rates Investec charges clients (relative to the rates shown in Table 8.1.1) are shown in Table 8.4.3.

There are some avenues of increased access to high-end, competitive services, with BOE Bank (formerly Syfrets, and the third-best-rated private bank in the PWC Survey) requiring a minimum balance of R50 000 for call, notice and fixed deposits, and Old Mutual Bank stipulating a lower level of R20 000 for fixed deposits although this lower entry level comes with lower returns (some 100 basis points below the return offered by Investec).

8.4.3. Service features and costs

Investec's private banking service is predominantly an on-line service, allowing for transactions to be paid and scheduled via the internet (at no cost) via a single account acting as a current account, linked to a Gold Visa card and a petrol card (which costs R2.50 to use per transaction). A call centre supports transactions.

The Visa card can be used internationally as well as within South Africa as an ATM card (at R7.50 a withdrawal, regardless of location), and is linked to a loyalty programme and travel insurance (as is the case with other gold credit cards in South Africa). Overdrafts at 100 basis points less than prime are offered to clients for 60-month periods and positive balances earn a premium call rate with no minimum balance required.

Investec charges a flat monthly fee of R45 for debit orders and transfers, lost card protection and the delivery, renewal and replacement of cards. The bank does not, however, offer a cheque account as it not a member of the electronic codeline to debit-clearing PCH (or the paper credit PCH), (discussed in Chapter 6), as this would considerably increase the cost of service provision. An alliance exists with ABSA for clients to deposit cheques.

A comparison of Investec's fees with those of one of the Big Four retail banks is made in Table 8.4.4. While Investec provides an incentive for electronic transactions, the big bank does not, imposing a limit of 15 cheques, cash deposits and withdrawals as part of the monthly fixed bundle. It is apparent that there is a group of the 'super-included' (the very wealthy who have reduced fees and preferential rates), who enjoy a clear advantage in banking.

Table 8.4.1 Investec Private Banking

(UK GAAP, £'000)	30 September 2003	As a % of Total income
Net interest incomes	36,867	53.7%
Net fees and commissions receivable	29,536	43%
Dealing profits	1,456	
Other operating income and dividends	852	
Admin expenses and depreciation	(42,522)	
Provision for bad and doubtful debt	(4,426)	

Source: Interim Report, ending 30 September 2003

Table 8.4.2 Investec Product Specials

(as of 13/01/04)	Nominal	Period effective
Protecta, Maxima and Extenda 6 month deposits	7.25%	7.36%-7.50%
Deposit Period: 6 months; prime linked with a base rate of 6.00		
Adjusta 12	7.00%	7.23%
Deposit Period: 12 Months fixed		
Prorata Fixed Rate	6.85%	6.95%
Deposit Period: 6 months; R100k minimum investment		
Prorata Variable Rate	7.25%	7.36%
Deposit Period: 6 months prime linked; R100k minimum investment		
Matura Plus	7.50%	7.62%
Deposit Period: 6 month prime linked. Over R100k; only over 50 years of age		

Source: Investec Website

Table 8.4.3 Investec Lending rates

(as of 13/01/04 - subject to Credit Committee approval)	
Investec Prime rate	11.50%
Investec Mortgage Bond base rate	11.50%
Private Bond - Debt Consolidation Facility rate (Private Variable rate)	9.50%

Source: Investec Website

Table 8.4.4 Service fees of high-end accounts

Transaction fees	Top bank – high-end client	Investec - Current account holder
Monthly service fee	R 125.00	R 45.00
Includes:		
15 cheques		No cheques
10 ATM withdrawals		R7.50 each
2 cash deposits		ABSA fees applies
25 electronic transactions (including transfers, debit and stop orders, account payments)		Unlimited
5 branch cash withdrawals		ABSA
but excludes		
Additional debit orders	R2.50 plus 1% of value - to a maximum of R25.00	No charge

Source: Investec Website

In this section, current accounts and credit cards are considered together, since they both allow credit and transmission facilities, and they are generally available only to middle income (and wealthier) consumers. In addition, these facilities are predominantly offered by banks[5].

The analysis of current accounts and credit cards will examine:

- Market shares of major providers.
- Fees (for various types of current account configurations and credit cards); and
- International and local comparisons on charges and interest rates for a range of similar products.

The market shares of major providers of overdrafts and other loans (which may be seen as a proxy for current accounts), together with the market shares of credit cards are shown in Figures 8.5.1 and 8.5.2. **It is clear that the Big Four banks dominate the market, making up 95% of the credit card market and 94% of the overdraft and other loans market in March 2003.**

The data for share of overdrafts and other loans has remained relatively static between June 1999 and March 2003, however, in the case of credit card shares, Nedcor's share has declined significantly, allowing for an increase in the share of ABSA and Standard. If the threshold of 25% to indicate scale monopoly is applied (see Appendix 1.2, Chapter 1), then in March 2003, ABSA and Standard bank had scale monopolies in the credit card market and Standard bank had a scale monopoly in the current account market[6].

The Cruickshank Report identified that the relatively high levels of concentration in the current account product segment in the UK was a concern as consumers relied on current accounts for access to other financial products (Cruickshank, 2000: p.130). The joint supply of other financial services with a current account means that the current account is key to competition in the retail financial market. Barriers to switching, as well as the costs thereof, were identified as factors which undermine competition in the current account product segment. While these factors may constrain South African consumers, the perceived lack of viable alternatives, particularly at the low-end, are likely to be an even more significant deterrent to switching.

While 8% of the total population (generally in LSM 7-10) are estimated to have current accounts in 2003 (Finscope, 2003), the blurring of the functionality between savings accounts with transmission facilities and current accounts, means that there is some degree of substitutability between these accounts, and that access for lower-income individuals to at least basic transmission facilities are generally available through the saving account mechanism.

Traditionally, banks make money from the positive balances held in current accounts, on which little or no interest is paid. In addition, interest on fees and overdrafts are charged[7]. In South Africa, transaction fees are applied for each service, except where the consumer elects to have a bundle of services, for which a composite monthly service fee is charged.

Minimum monthly service fees for the current accounts of major South African banks are depicted in Graph 8.5.1, and the annual credit card fees for entry-level accounts are shown in Graph 8.5.2. While the average annual fees for credit cards of the Big Four have increased by 29% since 1999, **the average service fees charged for current accounts have doubled over the same period. The ability of the Big Four banks to increase fees in the credit card market may be checked by the non-bank competition in the segment.** The service charges are one of many charges imposed by banks, including cheque book fees, cheque fees, stop orders, etc. These exclude any charges for overdrafts.

The SA Competition Commission findings on charges for various current account services reveal that South African banks charge fees for more services than international counterparts. Table 8.5.1 shows a sample of banks used to benchmark the fees charged by South Africa's Big Four banks. The sample includes five UK banks, one Irish bank, three USA banks, one Canadian bank, one Singapore bank, two New Zealand banks, two Australian banks and one Swiss bank.

The shading in Table 8.5.1 indicates where fees are charged. While SA banks charge fees for all the services listed, this is not so of banks in other countries. In terms of prices, although fewer fees are charged in other jurisdictions, where they are levied, they may be higher than in SA. (This assumes that the current exchange rate can be used as a fair means to evaluate other pricing regimes which have higher standards of living.) In the UK, US, Singapore and Switzerland most fees are zero or very low, with one or two exceptions such as dishonored payments, which are more expensive than in SA. The fees in Ireland, Canada, New Zealand and Australia are all cheaper than in SA.

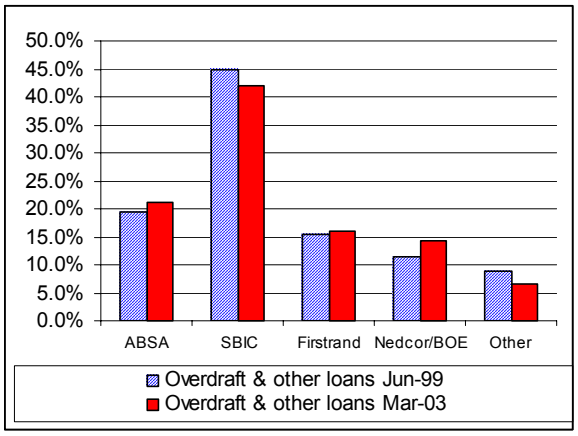
These comparisons are relevant, as local banks insist that their high transactions fees make up for the shortfall due to the Usury cap on interest rate charges. Reliance on fees is reflected in the increasing shift to non-interest income as a share of total bank income in the industry, as described in Chapter 4.

[5] Current accounts are exclusively offered by banks.

[6] These data are for advances through the banking system alone and exclude retail credit. Private-label credit cards, which are provided by clothing retailers for example, offer a popular avenue of credit for South African consumers. An estimated 4.9 million store accounts provided close to R6 billion in credit in September 2002 (FEASibility, 2003a, page 42).

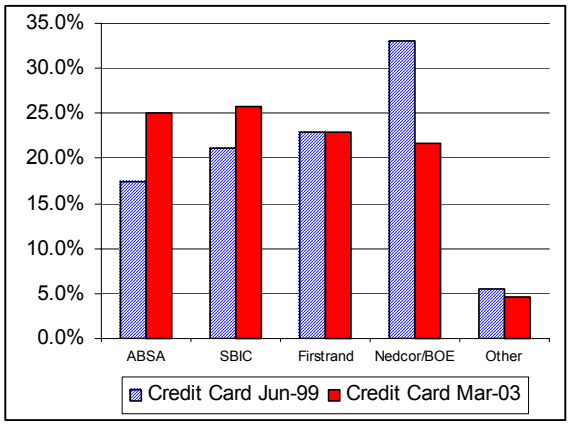
[7] In the UK, where consumers are not generally charged transaction fees, a bank may not have an incentive to provide a standard current account to low income customers, as a minimum balance beyond the means of low-income earners may be required to cross-subsidise transactions. Cruickshank (2000: p.185) estimated that an average balance of about £1 000 a year would be required to make a profit. Nonetheless, the Cruickshank Report argued that it is highly likely that supplying the bundle of basic banking services described above would be a profitable activity if no interest were paid on balances and the number of face-to-face transactions was low.

Figure 8.5.1 Market share of overdrafts and other loans



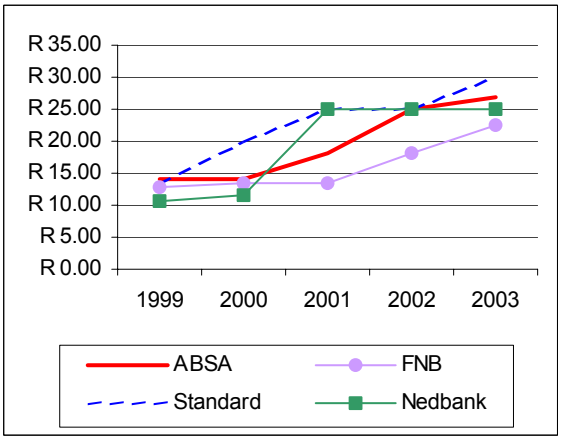
Source: Bank Supervision Department

Figure 8.5.2 Market share of credit cards



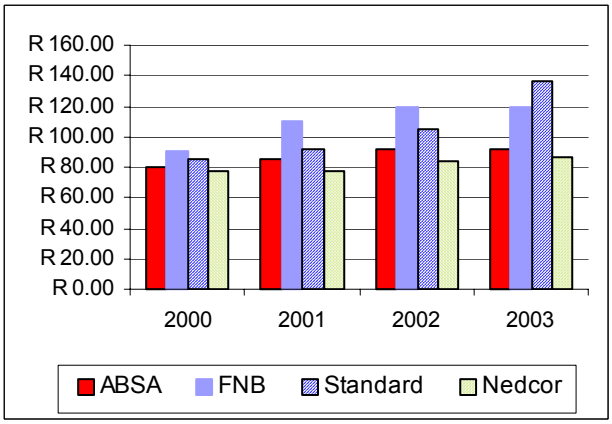
Source: Bank Supervision Department

Graph 8.5.1 Monthly service fee current account – March 2003



Source: Infochoice

Graph 8.5.2 Annual service fee entry level credit Card (together with lost card protection)



Source: Infochoice, verified with banks

Table 8.5.1 Charges for basket of services

Basket of services	United Kingdom					Ireland	United States			Canada	Singapore	New Zealand		Australia		Switzer-land	South Africa			
	Abbey National	Lloyds Bank	Halifax	Barclays	Natwest Bank	Bank of Ireland	US Bank	Bank of America	Citibank	Canadian Western Bank	United Overseas Bank Group	ASB Bank (NZ)	ANZ Bank (NZ)	Australia	BankSA	UBS Bank	ABSA	FNB	Standard Bank	Nedbank
Cash deposit						■											■	■	■	■
Cash withdrawal						■	■					■	■	■	■	■	■	■	■	■
Statement		■	■	■	■				■	■	■	■	■				■	■	■	■
Cash deposit						■						■					■	■	■	■
Cash withdrawal						■				■		■		■	■		■	■	■	■
ATM statement											■	■			■		■	■	■	■
Account payment						■						■	■				■	■	■	■
Debit orders						■				■		■	■	■	■	■	■	■	■	■
Returned cheque	■		■	■	■	■	■		■		■	■	■				■	■	■	■

Shaded area indicates that a charge is levied for the service

Source: Infochoice, SA Competition Commission

8.6 MORTGAGES AND HOUSING FINANCE

This section examines:

- The significance of mortgages and housing finance.
- The skewed access to mortgages.
- The gap in the retail mortgage market.

The bulk of South African consumer credit is used for housing purposes, with mortgages accounting for 55% of credit extended to households (FEASibility, 2003a, p. 9).

Mortgages are the cheapest form of credit accessible to consumers. In addition, access to a mortgage generally implies access to other products such as current accounts and credit card. However, given the racial dimension of property ownership, this credit avenue has been accessible to only a minority of South Africans. Skewed access is further exacerbated by the impact of inflation on housing subsidies and constraints on township mortgages[8].

Market share relating to bank originated mortgages is depicted in Figure 8.6.1. It is clear that ABSA has the lion's share of the market, amounting to 32% in March 2003. This puts them above the scale-monopoly threshold suggested in Appendix 1.2 (Chapter 1). It appears that the loss of market share of other banking institutions between June 1999 and March 2003 has been gained by the Big Four banks.

Not only banks provide mortgages in South Africa. In addition to the R191 billion book for residential mortgages, non-bank players in the sub-sector, such as SA Home Loans and National Housing Finance Corporation (NHFC) retail institutions, accounted for an estimated additional R7 billion in September 2002 (FEASibility, 2003a: p.27). However, this remains a small proportion of mortgages.

There are non-bank loans which are not mortgages per se, e.g. for home building or acquisition, secured by some alternative form of surety, such as a pension or unsecured micro-loans. They are included below to provide a fuller idea of the home financing options available to low-income households and individuals.

In particular, state-sponsored organisations such as the NHFC have contributed in various ways to increasing housing loan disbursements at the lower end. The 2003 Intergovernmental Fiscal Review records an amount of R1.2 billion dispersed since 1996. These disbursements have benefited intermediaries or brokers catering for middle-income clients. These intermediaries screen clients and resell mortgages to the NHFC. Since its 1996 inception, the NHFC has facilitated 164 996 loans, with a total of 25 new and emerging institutions established (2003 Intergovernmental Fiscal Review: 177).

Costs for the main providers of mortgages and housing to finance upper- and lower-income individuals are described in Table 8.6.1. At the upper end of the market, where the banks operate, the interest rate charged is generally well below the usury cap and is offered at around the prime rate. **At the lower end of the market, perceptions are that the security offered by housing stock will not be adequate and that surety from a pension or insurance from the Home Loan Guarantee Corporation may be required.** According to information from bankers, pension-backed loans are increasingly being considered by banks as options to diversify security risks.

Table 8.6.2 expands the description of the different types of loans as well as the costs of funds (with the Treasury bill rate used as a proxy) and the charge to the client. While the margins are likely to be higher for the low-end mortgages than for any other mortgage, the perceived risk remains an inhibitor. Since large banks are likely to obtain funding at cheaper rates than non-bank independents, the margin on high-end bank mortgages is likely to be higher than for high-end independent mortgages. Pension-backed loans tend to have shorter maturity and be small compared to other housing finance. In the case of the NHFC mortgages these involve intermediaries to originate the loan, although the risk shifts to the NHFC after 8 months.

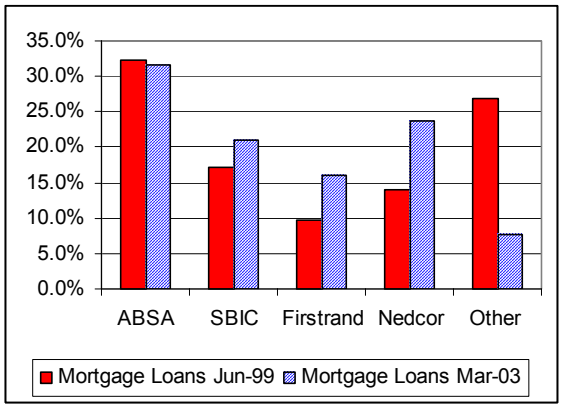
Pension-backed risk mitigation is important, as institutions such as the National Urban Reconstruction Housing Agency (Nurcha) have not managed to provide adequate security to financial institutions via the provision of guarantees (2003 Intergovernmental Fiscal Review: 177). Pension-backed loans are important in serving a gap in the market between specialist micro-lenders and high-end loans, the latter of which are subject to particularly intense competition. This gap becomes apparent when viewing the size of the book attributed to different loan sizes in Figure 8.6.2. Pension-backed loans are a relatively low-cost alternative to micro-loans, but the loans are restricted to the value of the surety they provide.

The data in Figure 8.6.2 show the skewedness of the mortgage / housing loan book, with the vast amount of financing accruing to the high end. This has social implications not only because alternatives to mortgages cost more, but because the absence of mortgages deprives households of the wherewithal to acquire property[9]. Of course, poorer households the world over tend to rent, rather than own, accommodation.

[8] A consequence of inter-related financial, legal, economic and social causes (FEASibility, 2003b).

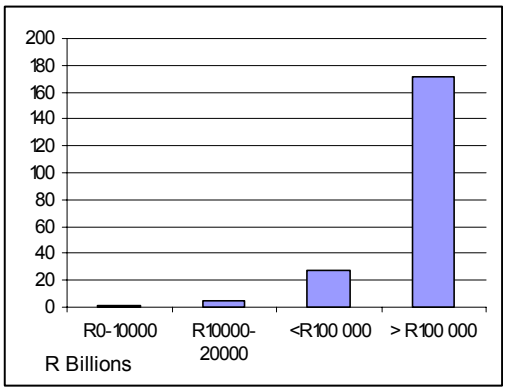
[9] The analysis here does not explore the factors undermining the functionality of the low-value secondary housing market. These factors include social, economic and legal constraints, which may account in part for the reluctance of the banks to offer mortgages in this market segment.

Figure 8.6.1 Market share for mortgages



Source: ABSA Annual report 2003

Figure 8.6.2 Mortgage / housing loan book by loan size (R billion)



Source: FEASibility, 2003a; revised

Table 8.6.1 Provider, costs, volumes and interest paid on mortgages

Life Style Measure	LSM 4-5 Low value mortgage	LSM 6-10 High value mortgage
Provider/Product	National Housing Finance Corporation, (NHFC) Pension backed Loan, Bank loans guaranteed by Home Loan Guarantee Corporation (HLGC)	Banks, SA Home Loans
Interest rate (%) Assuming prime rate of 11.5%	11.5 -14.5% p.a.	9.5-11.5% p.a.

Values updated for Prime at 11.5%

Source: FEASibility, 2003a

Table 8.6.2 Mortgage and housing finance costs

Type of intermediary	Cost of funds (% p.a.)	Ave. annual charge to client (% p.a.)	Form of security	Average loan size	Term of loan
Micro-loan - NHFC incremental housing	16	42	Unsecured	R4,660.00	21 months
Pension-backed loan	11	16-17	Pension fund	R20,000.00	8 years
NHFC mortgages - home ownership	13	17	Property - after 8 months risk shifts to NHFC	R80,000.00	15 years
Low-end bank mortgages	11	19-20	Property	R90,000.00	20 years
High-end bank mortgages	11	15-17	Property	R210,000.00	20 years
High-end independent	13.5	15	Property	R220,000.00	20 years

Charge to client and cost of funds calculated at a time when the prime rate was 17% p.a.

Source: FEASibility, 2003a

8.7 INTERNATIONAL COMPARISONS AND THE RETAIL SEGMENT

International comparisons discussed in Section 8.5 show that South African banks charge fees for services across the board. In this section, South African fees for a bundle of current account services are compared to those in selected other countries.

Current accounts are often used for comparisons of this kind as current accounts are seen as key accounts which allow entrée to other financial products (Cruickshank, 2000: 130).

The comparisons here are based on a bundle of services provided by a current account over the period of a year as defined in the Cruickshank report. The bundle includes:

- 300 Electronic funds transfers at Point of Sale (EFTPOS) Transactions e.g. debit card transactions (at an average of R250 per transaction).
- 100 Cheques (issued by the account holder at an average of R500 per transaction).
- 60 Stop orders (at an average of R250 per transaction).
- 100 Automated cash withdrawals (at an average of R500 per transaction)
- 50 ATM Deposits (at an average of R500 per transaction).

These fees are calculated in each local currency and then converted to Rands using the conversion rates shown below and shown in Table 8.7.1. South African banks charge an annual fee for current accounts as well as fees for EFTPOS transactions, cheques, stop orders, automated cash withdrawals **as well as deposits**. Canada is the only other country where banks charge for all the same transaction types as South Africa. Banks in the USA, Germany, UK and Australia charge for a limited range of transactions.

The data in Figure 8.7.1 show that UK banks tend to charge an annual fee only, while German and Australian banks use a combination of annual fees and other charges. The US banks in the sample appear to charge only for cheque issuing.

While the annual fees are relatively low in South Africa, the other fees charged by South African banks make them the most expensive current accounts, based on a comparative bundle of services. The data in Figure 8.7.2 show that the average costs charged by South African banks is R2 694.93, with the nearest rivals, Canadian banks, charging the equivalent of R1888.69 for the same bundle of services. Banks in the USA and German emerge as the cheapest for current account services.

Theoretically, charging fees for services is a sound business practice. The Wallis report (1997: p.144), for example, argued that product pricing should accurately reflect costs, since cross-subsidisation was increasingly unsustainable as consumers bought financial services from a range of providers. Fees or prices should hence ensure cost recovery. However, since competition is key to ensuring correct product pricing, where there is market concentration, the fees charged may not reflect costs. **The concentration of retail financial services in South Africa, may explain the very high fees charged by South African banks.**

Moreover, as is suggested by Figure 8.7.3, the net interest margin earned by South African banks is higher than every other banking regime except Australia[10]. This comparison is based on a deposit of £ 1000 (for which the local equivalent has been calculated), in a three month notice account. This suggests that **not only do South African banks charge more for services, they also offer lower interest rates on positive balances.**

The data in Figure 8.7.4 show the relatively high fees and interest charges accruing to a purchase financed by a mortgage in South Africa.

For comparative purposes, the local equivalent of a house purchase of £50 000 is assumed. This amounts to over R600 000, $93 000, AUS$ 120 000 and so on. The data show that only in South Africa and Germany do home purchases attract additional fees.

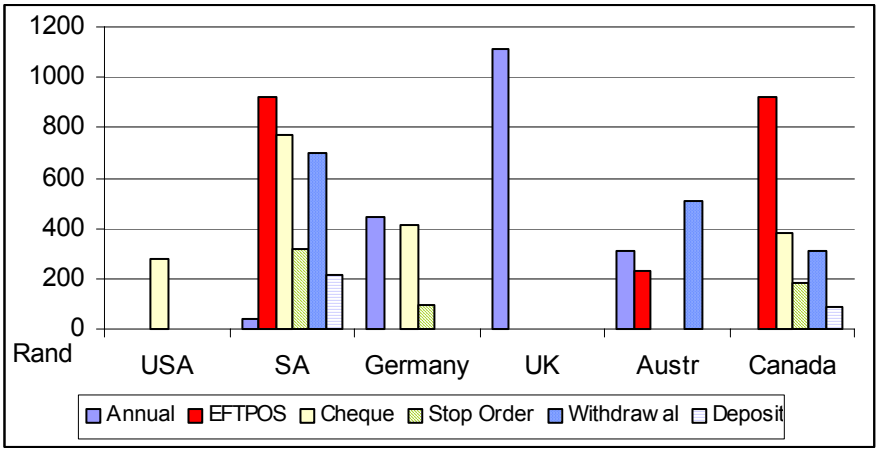
Despite the fact that mortgages finance is the cheapest form of finance available to South African consumers and even given what are now considered historically low interest rates, the interest charges in South Africa are far higher than that of other countries. Part of this cost may reflect the higher interest margin earned by South African banks than is earned in other countries.

Table 8.7.1 Exchange rates as at 1 March 2004

	US$	Rand	Euro	UK£	AU$	C$
US$	1.000	6.592	0.801	0.534	1.290	1.337
Rand	0.151	1.000	0.120	0.080	0.194	0.201
Euro	1.247	8.221	1.000	0.666	1.608	1.666
UK£	1.871	12.332	1.499	1.000	2.413	2.500
AU$	0.774	5.107	0.621	0.413	1.000	1.035
C$	0.747	4.929	0.599	0.399	0.965	1.000

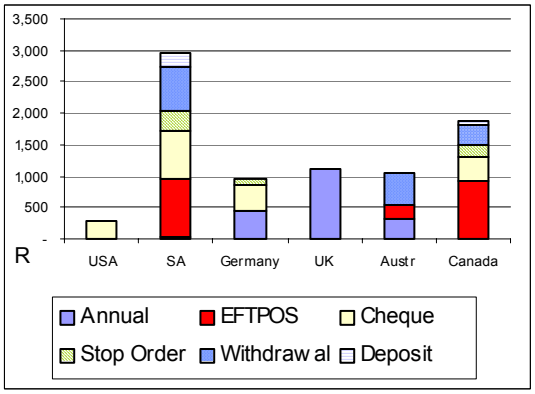
[10] The high net interest margin for Australian banks reflects a combination of a low deposit rate for amounts equivalent to £1000 (although they climb sharply for larger amounts) and a high return on money market rates.

Figure 8.7.1 Current accounts services for which fees are charged (by country)



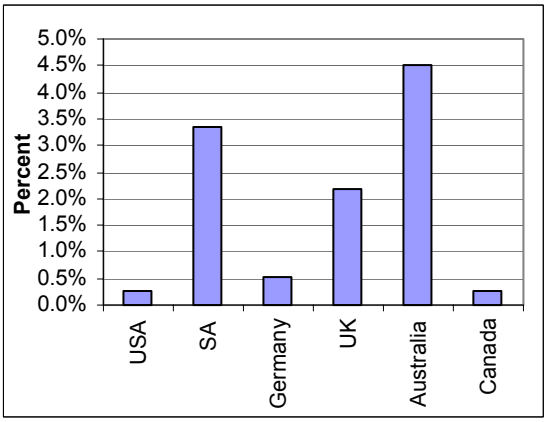
Source: See List below

Figure 8.7.2 Current accounts: Comparative fees for annual bundle of services



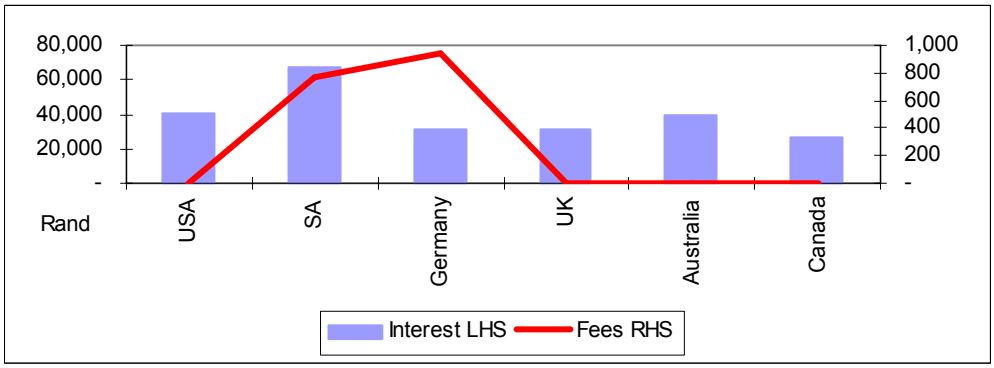
Source: See List below

Figure 8.7.3 Net interest margin earned by banks



Source: See List below

Figure 8.7.4 Costs for mortgage initiation



USA	Citibank, HSBC, Wells Fargo,
SA	ABSA, FirstRand, Standard Bank
Germany	Deutsche Bank, Dresdner Bank, Commerzbank
UK	Barclays, Royal Bank of Scotland, NatWest, HSBC
Australia	Commonwealth Bank, ANZ, HSBC
Canada	Royal Bank of Canada, Bank of Montreal
Source for Figures: Published information from following banks (Websites have been used in the case of banks in foreign countries) Averages have been used.	

Chapter 9

Banking services for small and medium businesses

This chapter consists of the following sections:

1. Definitions and contribution of the SME sector.
2. Financing and small and medium businesses.
3. Current accounts and small and medium businesses.
4. Banks and black-owned small and medium businesses.
5. International comparisons and small business banking services.

Worldwide, small firms are seen to have less access to financial services and lower success rates in obtaining funds than large firms. This chapter explores the position of small firms in South Africa.

The findings and conclusions of the analysis are as follows:

- Access to finance and the quality and cost of service that small businesses receive from banks are key to their profitability and prosperity (and that of the economy).
- Small and medium firms make up around 29% of all firms in South Africa and account for an estimated 42% of employment and 29% of GDP.
- Since 1994, new registrations of companies and closed corporations have been growing rapidly.
- During its existence an SME can access a number of different sources of finance, but there is little effective competition between the providers of such finance.
- Banks are reluctant to finance initial capital and even established businesses find difficulty in accessing working capital.
- The lack of competition in banking restricts choice for SMEs and increases the cost of access to banking services.
- Some 1.2 million SME accounts are held with the big banks, of which around 1 million are small business accounts.
- The deposits of small businesses are three times that of the advances extended to them. The ratio of deposits to advances is smallest for medium-sized firms.
- Small firms pay a premium for access to financial services, in terms of both interest rates and fees, relative to individuals.
- While overdraft finance for black-owned firms does not appear to be predicated on sound financial management practices, applications for cheaper and longer-term loan finance are twice as likely to be successful if financial management is practised.
- Small firms in South Africa pay more for a similar bundle of services than their counterparts in the US, Germany and Australia, but less than their counterparts in the UK and Canada.

9.1 DEFINITIONS AND CONTRIBUTION OF THE SME SECTOR

Because of scale and risk factors, Small and Medium Enterprises (SMEs) face higher borrowing costs and more onerous loan conditions than larger businesses[1]. However, even given these factors, market power may mean that smaller firms are being overcharged for bank services[2].

The investigation into SME access to finance in South Africa (Falkena et al, 2001) concluded that increased competition in the small business segment could improve both the access to and cost of services for SMEs. The report employed the National Small Business Act definitions of Small (fewer than 50 employees and turnover of R2 million to R25 million) and Medium (fewer than 100 employees and turnover of R4 million to R50 million).

The categorisation offered by Ntsika (2001) (shown in Table 9.1.1) distinguishes between informal and formal businesses. Banks and other commercial financial institutions cannot be expected to provide for businesses that are not registered.

The first three categories of Table 9.1.1 refer to survivalist and micro businesses. Many of these businesses are not registered for tax, and they are by definition not registered for VAT. Where the entrepreneurs running these businesses do have accounts, it is likely these would be individual accounts, rather than in the name of the business.

It is conventional in studies of this sort[3], to focus exclusively on those firms that are no longer treated as personal customers by providers of money transmission services and credit, but are too small to have direct access to competitive capital markets. In general this should mean the categories from very small to medium in Table 9.1.1 apply here. However there is a high proportion of small businesses in South Africa that still make use of personal accounts (the SME report 2001, estimated it to be around 25%). Section 9.3 explores reasons for this.

The exact number of SMEs is difficult to quantify, given the informal nature of the survivalist and micro enterprises. Estimates vary from around 1 million (Ntsika, 2001)[4] to 2,9 million (Business Partners, 2000). The number of registrations of companies (Pty) Ltd and closed corporations (CCs) is shown on an annual basis in Figure 9.1.1. Since 1994, the pace of registrations has picked up so that since 1994, some 200 000 companies and 645 000 closed corporations have registered. This represents an annual growth of 17% p.a. While the growth of CC registrations has grown relatively consistently, the number of company registrations peaked in 2000, but after a dip in 2001, registrations once again picked up in 2002.

The contribution of all SMEs to employment is set out by sector in Figure 9.1.1. An estimated 5.2 million individuals are employed by SMEs. SMEs account for around two thirds or more of the employment in the catering and accommodation, agriculture, community and social services and wholesale trade sectors. In all, over 20% of total SME employment is in catering, accommodation and agriculture. These data show that all SMEs (including micro-businesses) account for 54% of all employment (Registrar of Companies, 2003).

The contribution of small, medium and micro businesses in terms of employment and GDP is set out in Table 9.1.2.

Very small, small and medium businesses make up around 29% of all the firms in the country and contribute around 42% of the total employment and 29% of Gross Domestic Product (GDP). This compares favourably with informal survivalist and micro firms who make up just over 70% of all firms and account for 12% of total employment and 6% of GDP. By contrast, large firms make up 0.7% of all firms, but account for 46% of the country's employment and 65% of GDP.

Given that there are an estimated 6000 large firms in South Africa, the contribution of a few large firms may appear to be disproportionate. **Large firms nevertheless rely on the performance of smaller businesses for demand and supply. For this reason, access to finance and the quality and cost of service that small businesses receive from banks are key to their productivity and prosperity (and to the productivity and prosperity of the economy).**

[1] There is evidence of these higher charges in Australia, UK and, as we shall see, South Africa.
[2] UK Competition Commission, 2002, came to this conclusion.
[3] Cruickshank, 2000, for example used this definition.
[4] This is low given that there are an estimated 1.2 million SME bank accounts (See Section 9.2).

9.1 DEFINITIONS AND CONTRIBUTION OF THE SME SECTOR

Table 9.1.1 Classification of SMEs

Sector	Description	Number of employees	1. Annual turnover 2. Loan sizes 3. Access to banking facilities
Survivalist	• Income generated is below poverty line	• No employees	1. < R10 000 2. Average R500 3. None
Micro (0)	• Turnover is less than VAT registration limit • Not usually formally registered for tax or accounting purposes	• No employees	1. R10 000 to R25 000 2. Average R1 000 3. Possibly individual account
			2. Average R7 000 3. Individual account
Very Small	• Operate in formal market	• Less than ten employees	1. R50 000 to R200 000 2. Average R25 000 3. Entry Level Business Account
Small Enterprises	• Distinguished by some form of managerial co-ordination	• Less than 50 employees	1. R200 000 to R5 000 000 2. Average R70 000 3. Business account
Medium Enterprises	• Further decentralization of decision making • More complex decision making • Increased division of labour	• Less than 100 employees (200 in mining)	1. R 500 000 to R50 000 000 2. Loan size is dependent on sector, region and institution providing finance. Average R150 000 3. Business Account with additional facilities

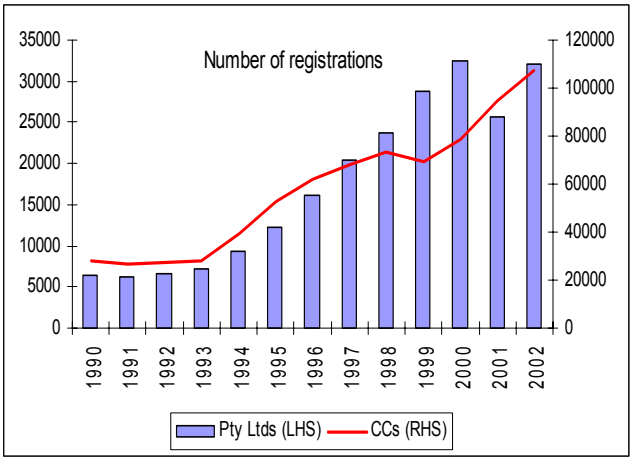
Source: Ntsika, 2001. Falkena et al, 2001

Table 9.1.2 Proportion of enterprises and their contribution to employment and GDP

%	Survivalist	Micro (0)	Micro (1-4)	Very Small	Small Enterprises	Medium Enterprises	Large
Numbers of firms	19.6	31.3	19.8	20.5	6.8	1.3	0.7
Employment	2.2	3.5	6.5	13.0	15.7	13.0	46.1
GDP	5.8			13.9		15.0	65.2

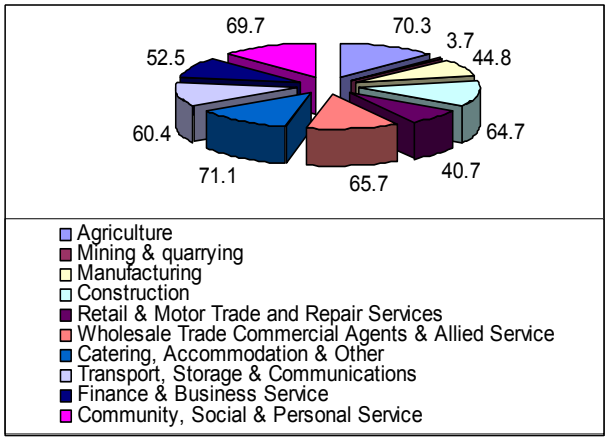
Source: Ntsika, 2001

Graph 9.1.1 Number of registrations



Source: Registrar of Companies

Figure 9.1.1 SME contribution to employment by sector



Source: Registrar of Companies

9.2 FINANCING AND SMALL AND MEDIUM BUSINESSES

In this section, bank and non-bank alternatives for small and medium businesses will be explored.

For a number of reasons SMEs may experience more difficulties than larger firms in obtaining funds[5]:

- **Scale:** SMEs tend to seek finance for relatively modest amounts. The fixed costs involved in searching, assessing and monitoring a loan or investment make it disproportionately more expensive to provide funds to a SME (see for example Table 9.1.1, where even medium-size firms seek average amounts of R150 000).
- **Risk:** SMEs are perceived to be higher-risk propositions. Start-ups and high-growth firms often lack a track record.
- **Reporting:** SMEs frequently have difficulty providing good quality information, and media or stockbroker reports are rarely available.
- **Seasonal nature of business:** Some types of SMEs, such as primary producers, have special financing needs owing to the seasonal nature of their business.

It may well be the case that it is not so much the availability of debt finance[6], but the inefficiencies in terms of product range and the cost of such finance that constrains the growth of SMEs. It remains difficult to differentiate those who prefer to use their own funds from those who use own funds in the absence of any alternative.

One way of examining the range of products offered to and required by SMEs is to link it to the stage of development of the business. Table 9.2.1 sets out different types of small businesses (traditional, high growth potential and high tech) and their possible sources of finance over the life of the business. The latter two categories are in the minority the world over (making up perhaps 15% of all SMEs). South African SMEs are unlikely to be an exception.

Bank debt is unlikely to be the primary source of financing for SMEs of whatever type during the start-up phase. The extent to which it is available is likely to be linked to surety provided by property or government guarantees. In subsequent phases, bank finance may become more readily available, although again it may be linked to the value of the order book (factoring[7]) or other surety.

While during its existence SMEs can choose from a number of external financing instruments: overdraft, bank debt, asset finance (including commercial mortgages), and equity (both business angel and formal venture capital), given the type of the business and its growth phase, in practice these instruments are not necessarily substitutes. The requirements of the providers of the finance and the impact on the business of taking such finance mean that there is little effective substitution between possible providers of finance.

Since the small business finance segment in South Africa has an under-developed venture capital market and is perceived by banks as risky, it is no surprise that the majority of small business funds comes from own savings, and loans from family and friends.

Various surveys confirm that commercial start-up finance is generally very difficult to obtain and would-be entrepreneurs rely on savings, mortgages or on the goodwill of family and friends. The results are summarised in Table 9.2.2. Sources of reported start-up capital were probed in three separate recent surveys. Between 73% and 94% of those surveyed reported that they made use of own funding rather than external financing. In a recent survey of 400 established entrepreneurs in the townships (of which only 6% obtained external financing) the predominant obstacle cited for not obtaining finance was lack of surety. Conversely, the primary reason why external finance was perceived to be accessible was possession of surety (home or pension-fund) (Progressus, 2004).

From the banks' perspective, there are both financially related and non-financial elements to assessment of SMEs. Typically, a bank will be interested in the skills and experience of the entrepreneur. Historically disadvantaged individuals (HDIs) score poorly in these categories.

In a study of disadvantaged entrepreneurs, the South African Global Entrepreneurs Monitor (GEM) 2002, found common obstacles preventing a candidate from borrowing money for business purposes. These were: blacklisting, inadequate financial records, lack of collateral and seeking working capital. Of those rejected, 75% reported one or more of these obstacles. Both lack of collateral and seeking working capital relate to the question of the applicant's own capital and the difficulties of accessing productive capital without it.

While more established businesses may have a greater likelihood of obtaining bank credit, even for established businesses, both the range of potential credit providers, and the possible product lines available to SMEs may be restricted. From a study of established 360 firms run by HDIs, (which had been in business for an average of 6 years) a third of those who had applied for commercial finance obtained it. However, they were three or four times more likely to obtain the credit if they asked for the relatively pricey options of a bank overdraft or credit card than if they applied for loan finance. The HDI entrepreneur was far more likely to be successful if applying for a *secured* loan.

[5] See Wallis, 1998 page 510.
[6] For example, in the SME Access report, 2001, p. 79. and Joffe, Business Day, 20 October 2003.
[7] Factoring and invoice discounting is essentially restricted to medium sized business. (In South Africa around 1200 businesses are served this way, with a total book of R6 billion in 2003 (Debtor financing Committee, Banking Council).

Table 9.2.1 Growth phases and funding requirements of SMEs

	Start-up Phase	Growth Phase	Stable/ Consolidation	Exit
Type of SME	Source of Finance			
Traditional small business. Provides employment for individual, family and friends	Family, friends, savings, **equity in residential property, loans underwritten by government**	**Asset-backed finance, bank debt**, **factoring,** trade credit	**Bank debt** if required	N/a
High Potential. Possibly export business	Angel finance, **Team's equity,** some venture capital	Venture capital, private equity, **asset-backed finance, some bank debt**	Venture capital high-yield debt market, **bank debt**	Exit via capital markets or direct access to stock market
High-tech, information and life sciences intellectual Property	Angel finance, venture capital, corporates	Venture capital, corporates, **Asset-backed finance**	Corporates, bank **debt**	Exit typically through trade sale

Source: SME Access to Finance Report, Falkena et al, 2001, quoting the UK Cruickshank report

Table 9.2.2 Sources of start-up finance

	Soweto*	Eastern Cape**	Johannesburg***
	Percent of respondents indicating they used ea source		
Own Savings	55	75	49
Family	8	10	29
Friend	0	2	-
Bank/MFI	1	0	24
Retrenchment package	18	3	10
Spouse	3	7	-
Other	19	3	8
Share who rely on saving (own, family, friends or retrenchment)	**94.2%**	**92.8%**	**73.3%**
* = 788 Businesses surveyed in 2003 by Vulindela Development Finance			
**= 1819 Businesses surveyed in 2003 by Vulindela Development Financ			
*** = 800 Businesses surveyed in 1999 by the World Bank			

Source: Vulindela Development Finance; World Bank

Table 9.2.3 Bank finance success rate

Applications for finance (HDI SMEs >3 years old)				
	% applying for finance	**% who were successful**	**% who accepted offer**	**% who received finance**
Bank loan secured or unsecured	84.4	25	85.2	18
Bank overdraft	18.8	62.5	76.7	9
Bank credit card	2.3	83.3	60	1.2
Micro-lender	3.1	0	0	0
Stokvel	1.2	33.3	100	0.4
Mortgage	0.8	100	100	0.8
Venture capital	0.4	0	0	0
Average		**33.2**	**82.4**	**27.3**

Source: GEM, 2002

The Big Four banks provide banking services to small- and medium-sized businesses[8].

While successful small businesses may make use of market funds and other investments as receptacles for cash surpluses, many small businesses are likely to deposit such surpluses with the bank with which they have a current account.

There are about 1.2 million SME business accounts, of which only around a third are borrowers (ABSA (2003), SME (2001)). Standard and Nedcor each hold around a third of these accounts, while ABSA's stated market share is around 20%[9]. (See Tables 9.3.1 and 9.3.2.)

The data in Table 9.3.1 provide an example of the lending/deposit ratios of the big banks (in this case ABSA, which alone among the big banks provides this kind of disclosure in its annual report). While the deposits of small businesses taken together are over three times the advances to them; for large businesses, deposits for large corporation are almost twice that of total of advances. By contrast, the advances to medium-sized businesses marginally outweigh their deposits. Small businesses are seen as risky and may be risk averse, choosing to use own funds. Larger businesses have alternatives both in terms of deposits and credit facilities. Banks are more likely to advance loans to medium-sized businesses than to either small or large firms. Medium–sized firms are perceived to be less risky and have fewer non-bank alternatives.

The perceived risk of small enterprises means that when they obtain access to financial services it is at a premium. To illustrate the point, the interest rate and fees charged by one of the major banks on an SME account and an average personal current account were compared. On an overdraft of R10 000, the SME pays a 300-basis-point premium over that paid by an individual (the SME overdraft rate is 14,5% compared to the individual rate of 11,5% at a time when the prime rate was 11.5%). In addition, as is shown in Table 9.3.1, in every case where fees are charged for services, the fees for the SME are at a premium, so that the SME pays over 14% more for each transaction, compared to identical transactions conducted by an individual. While the interest rate premium may be justified on the grounds of risk, this argument does not hold for fees and other charges.

In the Costs, Volumes and Allocation of Consumer Credit Report (FEASibility, 2003a), evidence was lead by the banks that the Usury cap was an obstacle to servicing small businesses better. In the UK, where there is no Usury cap, the Cruickshank report concluded that the source of profitability from small businesses arose from money transmission services and deposit (savings) accounts.

Banks can exercise market power over small businesses because current account services and term loans are generally sold in a bundle. There are good reasons for doing this. The bank is able to price the risk of a loan more accurately when it has a long transaction history. Empirical evidence suggests that this advantage is real: SMEs tend to get relatively better loan rates the longer they remain with a bank. The overall effect of bundling therefore may give some individual SMEs a relative advantage, but it also means that a small number of banks can collectively exercise market power over the SME population as a whole. The relative advantage means that SMEs tend to switch current accounts rarely.

In South Africa, the combination of few competitors and the reluctance to switch has meant that small businesses tend to be a captive market and relatively price-insensitive. The Cruickshank report identified two barriers to switching: information problems and costs of switching.

The **information problems** relate to weak and partial disclosure. In general, consumers neither understand the terms of the products they hold nor are they able to make informed comparisons with the products of other providers. This lack of disclosure by banks encourages price insensitivity. Lack of disclosure to the small business segment appears to be a trend worldwide (see Section 9.5). In an exercise comparing international changes it was exceptionally difficult to obtain details of small business charges, relative to those on individual accounts. In addition interest rates on advances were virtually never disclosed on websites.

The **costs of switching** relate to the relative ease with which financial products can be switched. At one end of the scale, are credit cards, where consumers can transfer between providers at no cost to themselves, and consumers can hold more than one credit card account simultaneously[10]. At the other extreme are current accounts, where switching involves transferring debit orders, salary payments and mortgages. The latter involves redemption penalties and upfront costs like property valuation and legal fees. Both information problems and costs of switching appear to be a deterrent to small businesses shopping around for basic banking services.

[8] While Investec does have facilities for enterprises, the entry criterion is a minimum after tax profit of R2 million. This is likely to exclude all but successful medium-sized companies.

[9] Based on market share estimated from ABSA's Annual report 2003, and SME Report 2001.

[10] Not all credit cards are perfect substitutes, however, for example, Diners Card insists that the outstanding balance is settled in full monthly, whereas other cards allow more payment discretion.

Table 9.3.1 ABSA's Business Accounts

	R billion			
Size of Business	**Advances**	**Deposits**	**Number of Accounts**	**Market Share**
Large	R14.9	R28.4	3 000	10%
Medium	R11.2	R10.3	23 000	16%
Small	R2.6	R8.5	210 000	20%
Total	**R28.7**	**R47.2**	**236 000**	

Source: ABSA Annual Report, 2003, p. 108 & 109

Table 9.3.2 Small business book of major banks

	Standard	**Nedbank**	**ABSA**	**FNB**	**Total**
SME clients	367 500	346 500	210 000	126 000	1 050 000
Total book			R2.6 billion		R13 billion*
Average size of loan	R39 000		R47 000		
Market Share	35%	33%	20%	12%	100%

(Split of market share and average size of loan based on SME Report, Falkena et al, 2001)
* Probably on the low side but no data from Banking Council to date

Source: SME Report, 2001 and ABSA Annual Report

Table 9.3.1 Charges for SMEs and for individual current account holders

Scenario: SME Current account usage		
Description	Charge as SME	Charge as individual
10 cheques a month average R2000	R 251.00	R 225.00
R80000 cash deposited into account (in R5000 tranches)	R 729.60	R 720.00
R20000 received by cheque	R 0.00	R 0.00
Payment of 15 accounts electronically ave. R2000	R 196.50	R 187.50
Exceeds overdraft limit once	R 90.00	R 0.00
Overdraft fee for overdrawn balances	R 25.00	R 0.00
Withdrawal Own ATM R5000	R 45.50	R 45.00
Withdrawal other ATM R5000	R 51.00	R 51.50
TOTAL CHARGES FOR MONTH	R 1,469.85	R 1,285.25
Difference	14.36%	

Source: Bank brochures and statements, 2003/4

9.4 BANKS AND BLACK-OWNED SMALL AND MEDIUM BUSINESSES

Black-owned SMEs are the focus here, as the discussion so far has implied that for both financial and non-financial reasons, banks may be reluctant to lend to this category of small business. In addition, the subject has become particularly topical since the Financial Sector Charter has committed the banks to increase black small-business financing. While disclosure in terms of financing to small businesses has been relatively weak to date, this commitment means that at least in terms of black-owned SMEs, performance disclosure by the banks will improve.

In terms of the Financial Sector Charter, black-owned or black-empowered companies with a turnover of between R500 000 per annum to R20 million per annum is the target group. This places the target group in the very small to medium business category, and excludes survivalist, micro and informal businesses.

While there is little definition of the exact details of the commitment, the charter states that the financial institutions will:

- Provide support to black-owned SMEs to enable them to benefit from targeted procurement programs.
- Promote early payment for services provided by SMEs.
- Encourage existing suppliers to address Black Economic Empowerment (BEE) and become BEE accredited.
- Support the establishment of third tier community-based financial organisations or alternative financial institutions.
- Ensure the provision of first-order retail financial services for small and micro enterprises (i.e. with no minimum turnover).

South Africa's history has undermined the accumulation of traditional sources of start-up capital by black entrepreneurs. Hence both own funds and fixed assets which can provide security for loans are relatively rare.

For example, many key assets in the townships are generally entirely disregarded by banks in calculating the relevant individual's net asset position. Reasons for this lack of recognition include the high probability of criminal damage to the assets or property, uncertainty over property rights; or the lack of a secondary market for residential property in the townships. Hence the key to providing more advances to small businesses may be the unlocking of institutional, infrastructural and legal constraints in the township property market.

The latest South African GEM report (2003) evaluates South African institutions against those of other developing and OECD countries. While the South African financial system appears reluctant to support emerging entrepreneurs, their performance is comparable with that of other developing countries in terms of supporting new and growing firms. In Argentina, Mexico, India and Brazil, the bulk of start-up capital also seems to come from own funds and the entrepreneur's informal personal network.

In its most recent survey of 224 black-owed firms, GEM (2003) interviewed firms that had an average turnover of R2.4 million and which had existed, on average, for 8 years. The details by firm type are shown in Table 9.4.1, with companies ((Pty) Ltds) having a larger turnover and on average, employing more workers, than closed corporations or sole proprietorships.

Of the firms interviewed, 63% had an overdraft facility, of which close to half (45%) had exhausted their overdraft within the past 6 months. This can be seen as an indication of financial constraint. Table 9.4.2 indicates that while sole proprietors or partnerships and CCs are more likely to reach their overdraft limit, more than 20% of companies also experienced this constraint. This result confirms the results discussed in section 9.2 which pointed to the difficulty SMEs experience in accessing productive capital, even once they are established.

In exploring reasons for reaching the overdraft limit, GEM examined the financial administration and management practices of firms. These included keeping a cashbook, keeping records of and accounts receivable, inventory and performing proactive debtor management. Table 9.4.3 suggests that the adoption of these financial practices reduces the likelihood of exhausting one's overdraft, although 32% of those that had exhausted their overdraft had adopted all the financial management practices identified here. Hence while cash flow difficulties are a persistent problem, good financial management practices reduce the possibility of cash flow difficulties.

Overdraft credit tends to be easier to obtain that loan credit. The latter tends to be longer term and cheaper. While overdraft financing does not appear to be predicated on financial management of the firm's cash flow, the same cannot be said for loan finance. The GEM study showed that 48% of the firms applied for loan financing, of which 61% were successful. As can be seen in Table 9.4.4, adopting good financial management practices was associated with a higher rate of success; 71% of those firms with good financial management practices indicated their loan application had been successful.

The link between financial management and access to finance has implications for the Financial Sector Charter, which has committed financial institutions to employing 0.2% of post-tax operating profit in consumer education. **Money spent on the education of entrepreneurs in simple financial management techniques may be money well spent, and may be a mechanism to ease financial constraints on existing firms.**

Table 9.4.1 Profile of black-owned businesses, GEM survey

Type of registration	Proportion of firms	Average Annual turnover	Average number of employees	Age of firm (years)
Sole proprietor / partnership	14%	R1.3m	8	9
CC	72%	R1.9m	11	7
Pty Ltd	15%	R5.5m	21	7
All	100%	R2.4m	12	8

Source: GEM, 2003

Table 9.4.2 Overdraft finance: limit by firm type

Applications for overdraft finance		224 firms
% with an overdraft		63%
% reached limit		45%
Incidence:	Sole proprietor	74%
	CC	45%
	Pty Ltd	23%

Source: GEM, 2003

Table 9.4.3 Adoption of financial management practices

Applications for overdraft finance		224 firms	
% with an overdraft		66%	
Adopted 4 financial practices			39%
% reached limit		45%	
Adoption of:	None of 4 practices		83%
	Some of 4 practices		50%
	All of 4 practices		32%

Source: GEM, 2003

Table 9.4.4 Loan application success and financial management

Applications for loan finance	224 firms
% applied for a loan	48%
% successful	61%
Success rate with financial management	71%
Success rate without financial management	42%
% with loan	30%

Source: GEM, 2003

This section compares the fees accruing to an SME current account for a bundle of services across six countries, including South Africa.

The comparisons here are based on an annual bundle of services provided by a SME current account as defined in the Cruickshank report. The bundle includes:

- 10 000 automated collections.
- 8 000 automated payments.
- 2 000 Cheque payments (issued by the SME to the value of R1 000 per transaction).
- 10 000 cheque collections.
- 100 Stop orders.
- 300 Automated cash withdrawals.
- 450 Deposits in the bank (at an average of R2 000 per transaction).

These fees are calculated in each local currency and then converted to Rands by means of the conversion rates in Table 9.5.1.

For services, the banks of all countries charge SMEs more than they charge individuals. (Fees accruing to individual accounts were discussed in Chapter 8.)

All countries charge for automated payment fees, except the USA (provided a minimum daily balance is maintained), and cheque payment fees, although banks in Germany, the UK, Australia and Canada apply charges for cheque deposits. The data in Figure 9.5.1 show the incidence of fees for the different services. USA banks appear to charge only for cheque payments (issuing) and cash deposits, provided a minimum daily balance is maintained.

In Figure 9.5.2 the annual cumulative fee for the bundle of SME services is shown. While these data exclude the monthly fee for the account, it is apparent that the banks in the UK and Canada charge the most for the bundle of services provided by South African banks. Expressed in South African Rands, UK banks charge an average of R113 885, Canadian banks an average of R104 201, and South African banks R87 800 for the same bundle of services. In comparison Australian banks are the cheapest, charging the equivalent of R35 680.

While the charges by South African banks are 2.5 times that of their Australian counterparts, the South African banks charge only 75% of the amount charged by their UK counterparts.

In Figure 9.5.3, the comparative fees for the same bundle of services for a personal current account and a small business account are compared. In other words, the fees are calculated for the same bundle of transactions as if originated in a personal capacity, using an individual account. In Germany, a small business pays over 5 times that which an individual would pay for the same bundle of services, since its individual fees are so low. In the UK, small businesses pay over twice as much and in Australia they pay 1.5 times as much as individuals would pay. In South Africa the premium paid by small businesses is 20%. **This explains why very small businesses may be inclined to originate their business transactions from their personal accounts.**

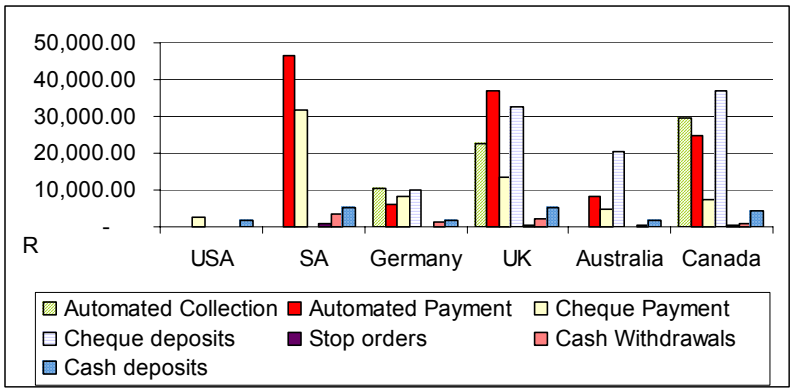
The premium paid by small businesses for bank services, and in particular transaction facilities, suggests that the world over, **the source of profitability from small businesses may arise from transaction fees.**

While the premium that small businesses pay over individuals for transactions in South Africa appears to be relatively small in international terms, **in South Africa fees for individuals are already high by international standards.**

Table 9.5.1 Exchange rates as at 1 March 2004

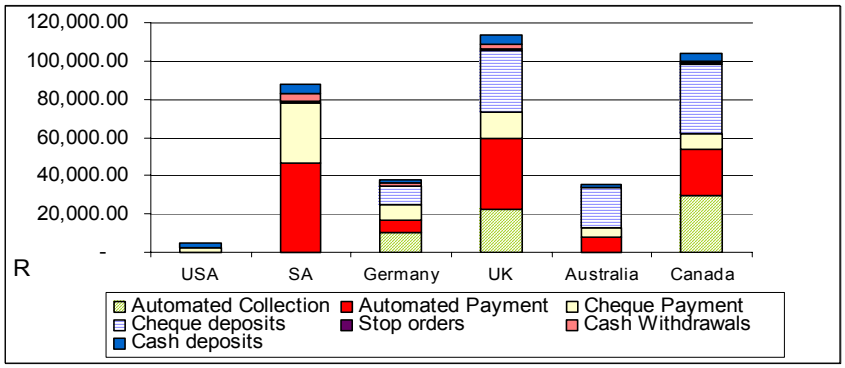
	US$	Rand	Euro	UK£	AU$	C$
US$	1.000	6.592	0.801	0.534	1.290	1.337
Rand	0.151	1.000	0.120	0.080	0.194	0.201
Euro	1.247	8.221	1.000	0.666	1.608	1.666
UK£	1.871	12.332	1.499	1.000	2.413	2.500
AU$	0.774	5.107	0.621	0.413	1.000	1.035
C$	0.747	4.929	0.599	0.399	0.965	1.000

Figure 9.5.1 Annual fee split for business current accounts



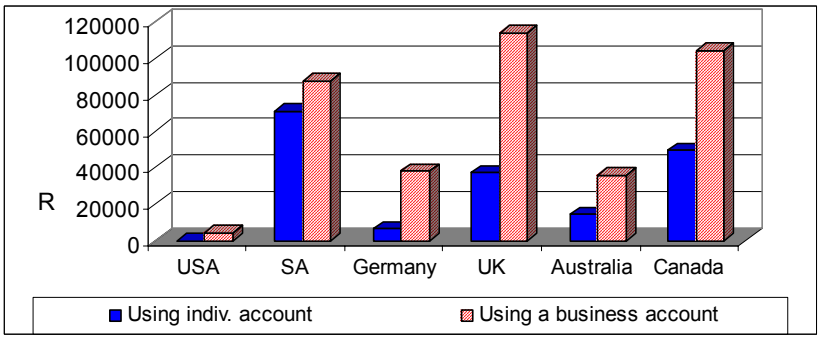
Source: Local and International banks' websites (see list below)

Figure 9.5.2 Annual cumulative fee for SME bundle of services



Source: Local and International banks' websites (see list below)

Figure 9.5.3 Small business account fees compared to those of an individual



Source: Local and International banks' websites (see list below)

Banks used for source data for above figures

USA	Citibank, HSBC, Wells Fargo,
SA	ABSA, FNB, Standard Bank
Germany	Deutsche Bank, Dresdner Bank, Commerz Bank
UK	Barclays, Royal Bank of Scotland, NatWest, HSBC
Australia	Commonwealth Bank, ANZ, HSBC
Canada	Royal Bank of Canada, Bank of Montreal

Chapter 10

Disclosure and corporate governance

This chapter consists of the following sections:

1. Disclosure to clients.
2. Disclosure to credit providers.
3. Disclosure to regulators.
4. Disclosure to shareholders.
5. Disclosure to stakeholders.

Key to the discussion is the extent of disclosure and the nature of the information imbalances. Information imbalances influence the ability of players to allocate resources correctly (Cruickshank, 1998 p.18), as well as the ability of regulators to assess the financial stability of the system. Information imbalances impair the assessment of clients and shareholders. For these reasons, lack of disclosure or partial disclosure can affect prices and the efficiency of the banking system as a whole.

The findings and conclusions of this analysis are as follows:

- While prudential disclosure to the regulator and shareholders is generally of a high standard, disclosure of pricing and other information to clients, other credit providers and stakeholders is often inadequate and impedes effective competition.
- The full cost of banking services (including initiation and transaction fees and bundled insurance products) are rarely spelt out, which means that the quoted rates for services often understate the cost of financial services.
- Bundling of products makes it difficult for customers to assess services, and disguises cross-subsidisation and differential pricing. It also acts as an information barrier to entry of non-bank providers.
- Standardised disclosure is neither regulated nor practiced and this, together with the complexity of the products offered, leaves clients disgruntled and confused.
- Banks share only a subset of information regarding client commitments with other credit providers. This contributes to the cost of origination on non-bank loans and increases risk exposure of client and provider alike. This makes it difficult for non-bank competitors to provide reasonably priced competition.
- Disclosure requirements stipulated by the South African Registrar of Banks have become increasingly rigorous in recent years and this has increased the input costs facing banks.
- In terms of board structure and other elements of financial corporate governance, South Africa's top banks generally perform well when compared to banks in the United States.
- Disclosure to the broader public, or stakeholders, is the mechanism by which the financial soundness and social functionality of the banking system is assessed. South African banks are beginning to respond to this aspect of disclosure.

10.1 DISCLOSURE TO CLIENTS

The disclosure of prices and terms to clients affects their ability to compare products. The functioning of the price mechanism presupposes that there is a free flow of information. "If consumers are making the right choices according to their needs, prices should reflect accurately their willingness to pay for particular products" (Wallis, 1997, p. 634). When consumers are unable to make the choices that reflect their needs because of information imbalances, this affects the efficient allocation of resources. The Cruickshank Report argued that it is a basic consumer right to be aware of the pricing of goods and services (1998, p. 95).

A study recently commissioned by the Micro Finance Regulatory Council, as part of the Credit Law Review, showed that it was difficult for field researchers, much less unassertive clients, to obtain comparative price information (FEASibility, 2003a). In general, disclosure of credit providers, including banks, was partial. In most cases, banks advertise the interest rates accruing to each product. In general these are benchmarked to the Usury cap, which is based on the prime rate of interest[1]. **Disclosure regarding fees and transactions are less forthcoming and generally not standardised. This, together with the bundling of services, undermines ease of comparison.**

An example of bundling is the linking of granting a loan to the holding of a current account, or an offer of a minimum balance current account which attracts no charges. The result is that the customer may be provided with a package that does not suit his or her financial needs. Apart from making it difficult for customers to select and assess affordability of services, bundling disguises cross-subsidisation and differential pricing. There are also information advantages to bundling (for incumbents) which act as a barrier to single product entry for non-bank providers (Cruickshank, 2000, p. 162).

Table 10.1.1 shows the implications of partial disclosure to clients. The data in the first column of the table are based on quotations from banks. In each case the advertised interest rate may not be the full cost of credit. In some cases, the benefit of the hidden or additional fees may not fully accrue to the banks, as in the case of transfer fees for home-loans or credit life insurance on personal loans. Nonetheless, in many cases they do. Credit card users are unlikely to be made aware of the implications of failing to repay their entire debt each month.

This raises the concern of the level of complexity of products offered, relative to the financial literacy of the client-base. While there has been successive legislation regarding better disclosure to clients, standardised disclosure is neither regulated nor practiced. None of the large South African banks have explicit policies on the disclosure of prices and while the financial media occasionally publishes comparisons (for instance of deposit accounts), these are infrequent and accessed by a small proportion of South Africans. In addition, such articles do not provide details of standardised packages.

The discrepancy between the published interest rates and the cost of credit is often (belatedly) noticed by clients. Areas of poor or no disclosure in credit markets (which affect banks as well as other providers) are listed in Table 10.1.2. They represent the responses of clients in group discussions, which assessed the extent to which consumers are aware of the cost of their credit, understand the concepts involved, e.g. interest rates or Credit Life Insurance, and feel that they have had a fair deal (SAtoZ, 2003).

Relevant policy issues relating to client disclosure in South Africa include:

1. The need for regulation to ensure standardised disclosure of certain products. Appropriate disclosure requirements would improve consumer protection and encourage appropriate behaviour. **Weak disclosure impedes effective competition, to the detriment of the consumer.**
2. Whether or not agents (such as the financial media) would emerge to provide information on comparable products.
3. The degree to which the banking registration requirements should require banks to comply with the requirement for timely, accurate and relevant price information. Without regulatory incentives, market participants tend to disclose as little as possible in view of cost and competitive advantage situations.

Improved disclosure would encourage more competition by empowering consumers and would-be entrants. Since the Cruickshank Report, disclosure in the UK banking environment has become far more rigorous and standardised. It is now possible, for example, **to obtain standardised comparative banking fees for all banks in a market segment from the UK Banking Association website,** which was not the case prior to 2000.

[1] The calculation for the Usury cap:
Prime rate of 5 leading banks plus 1/3 prime plus 6% for amounts up to R10 000 and Prime plus 1/3 plus 3% for amounts greater than R10 000.

Table 10.1.1 Partial disclosure to clients: Discrepancies between published and actual rates

Product type	Advertised annual interest rate[1]	Regulatory maximum[1]	Hidden or additional fees or charges[2]	Average percentage rate paid by the client
Home loan (mortgage of R300 000, say)	16.50% p.a.	Usury cap = 26% p.a.	Transfer duties, legal fees (can add over R20000 to bond of R300 000	17.10% p.a.
Credit card	23.00% p.a.	Usury cap = for amounts above R10 000 and 29% fro amount less than R10 000	Transactions fees, consequence of rolling over credit from one month to the next	51.80% p.a. (If only minimum balance is paid)
Personal loan (micro-loan) R5 000	Rate not specified, but monthly instalment advertised p.a.	No cap	Transaction fees, initiation charges, credit life insurance	83.00% p.a.

1= When Prime rate was 17%
2= While these may be mentioned in advertising material to the client, the financial implications are not spelt out to the clients

Source: Quotations from banks. Quoted in FEASibility, 2003a

Table 10.1.2 Areas of weak disclosure to clients

Hidden fee/charge	Areas of confusion revealed in focus groups
Credit life insurance	What it means, whether it is compulsory and who benefits from it
Penalties for missing payments	Penalties (in higher interest) for skipping a payment not disclosed
Additional products	Not told they can shop around for their own conveyancer
Insurance policies	Not informed that policy can be purchased elsewhere
Compound interest	The impact of compound interest on large purchases (cars and houses) is not explained. The fact that for the first years of repayment one is only paying off interest and none of the capital may come as an unpleasant shock.
Administration fees, registration and insurance fees	Not disclosed up-front

Source: SAtoZ, 2003, Comments based on consumer focus groups.

One of the problems highlighted in the MFRC's Consumer Credit Law Review (2003) is the inadequate information-sharing in the South African consumer credit market. In general, banks and non-banks do not share information and client information generally accrues with market share. Credit providers see client profile information as a competitive benefit to be protected. While this is likely always to be the case, the lack of information-sharing, not of client profiles so much as client commitments, has proved to be the undoing of provider and client alike.

The sharing of information with other credit providers is necessary to reduce the disadvantages of asymmetrical information and the cost of obtaining accurate client information. Where there is inadequate information about repayment behaviour and the current obligations of a client, the ability to assess risk is restricted. **There is no register of loan commitments in South Africa[2], which undermines the ability of all credit providers to assess risk.**

As risk assessment represents a major determinant of credit provision, the ability to price for bad debt is particularly pertinent where there is low price sensitivity among consumers, typical of poorer income groups who have less choice. In South Africa, where the extension of banking services to low-income groups is a priority, there is clearly concern where information regarding the loan commitments of clients is inadequately shared between credit providers.

Better access to this information would enable a more accurate pricing of risk that reduces the cost and therefore the feasibility of providing credit to lower income individuals. If the repayment profile were also shared as part of this process, it would encourage the extension of credit to individuals who represent acceptable risk profiles but who have otherwise been excluded from financial services.

Table 10.2.1 shows the extent of information sharing by banks with credit bureaux and the Furniture Traders Association. While credit card, personal loan and instalment sales information is shared with other providers, information regarding client obligations as they relate to mortgages, leases, pension-backed loans, overdrafts and student loans are not generally available. The incomplete information on clients' commitments undermines ability to screen for affordability, and discourages competition in this industry.

Lack of information can be seen as a barrier to entry for competitive markets. It does not appear to deter credit providers from entering the market but it does seem to increase the cost of screening and acquisition. For example, non-bank credit providers typically have to approach the credit bureaux for client information. Each discrete enquiry costs the non-bank provider around R5 per enquiry, although this cost reduces with numbers and large firms typically obtain bulk discounts. The lack of information-sharing is not unique to South Africa. The Cruickshank Report found that new bank entrants were found to struggle to gain information in relation to small business to assess their risk profiles. Such costs undermine the attempt to maintain appropriate levels of risk exposure (Cruikshank, Chapters 4 and 5).

The cost of asymmetrical information is indicated by the levels of bad debts in different market segments. Graph 10.2.2 presents the bad debt charges for different market segments. Furniture sales and term micro-lending display consistently higher bad debts than other market segments over the three years for which data are shown. The consistently low bad-debt ratios of banks, pre-screened personal loans and revolving store credit providers reflect access to good client-information and risk assessment procedures[3]. It can be argued that the low levels of bad debt associated with payroll deduction micro-loans relative to term micro-loans collected via debit order speak more of the relative security of collection than good client information. Nonetheless, the payroll deduction system also provides client-information.

Lack of information-sharing also locks consumers into certain provider categories. Better information-sharing may enable consumers to shift to cheaper products and providers.

In the South Africa information imbalances act to compromise non-bank competition for credit products, by increasing the cost of origination and of monitoring risk exposure.

[2] The MFRC has instituted a National Loans Register, but this is a compulsory listing of micro-loans only and does not provide micro-lenders a complete picture into the commitments of clients.

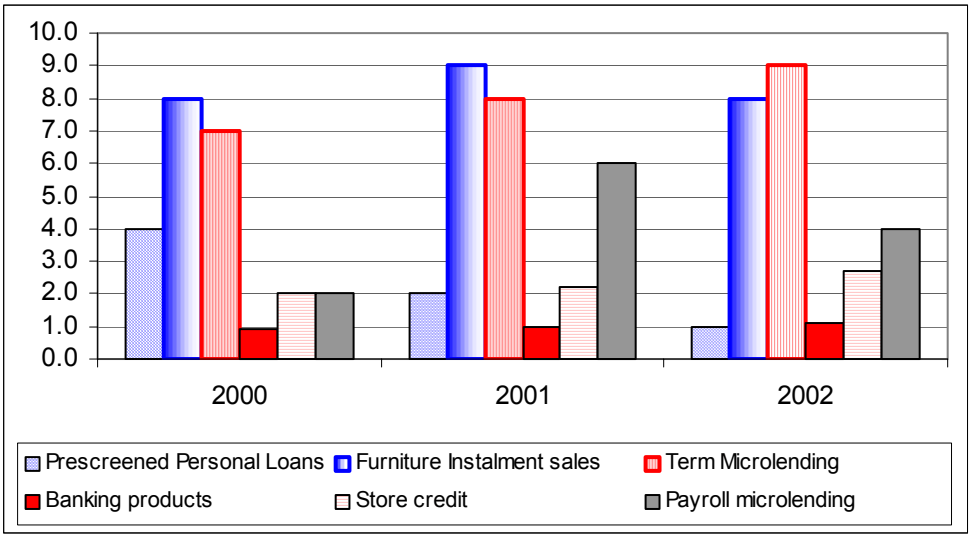
[3] It can also be argued that bad debt is directly related to the interest margin. For those credit providers whose net interest margin exceeds that of the banks, a higher level of bad debt is affordable.

Table 10.2.1 Extent of information-sharing

Bank information on Client Commitments	Shared?
Bank mortgages	No
Low-end credit card information	Yes
Bank leases	No
Bank overdrafts	No
Pension-backed loans	No
Personal loans	Yes
Student loans	No
Instalment sales (hire purchase agreements)	Yes

Source: FEASibility, 2003a

Graph 10.2.2 Bad debt charge as a percent of loan book: Various credit types



Note: Each category represents the average data of a minimum of two providers, with the bad debt charge expressed as a percentage of the average loan book over the current year plus the previous year

Source: FEASibility, 2003a, Financial reports of providers.

10.3 DISCLOSURE TO REGULATORS

In terms of disclosure to regulators, issues that need to be considered include:

1. Disclosure requirements (meetings and information returns.)
2. The role of market discipline in banking regulation, especially in light of the Basel II proposals.
3. The scope and efficiency of government interventions addressing the risks of failure of banks.

Both the Registrar of Banks and the banks confirm that regulatory requirements in terms of risk and prudential disclosure have grown significantly in recent years. Meetings with the Regulator may be classified into five areas:

- Meeting of a bank's Board of Directors – the purpose is to discuss the returns received from the bank by the Registrar. It provides an opportunity to raise concerns that the Reserve Bank may have with regard to the bank. The bank will present on a selected topic.
- Trilateral Meeting – Meeting between the audit committee of the bank, the Registrar of Banks and the External Auditors. The purpose is to discuss the management report prepared by the External Auditors, as well as issues raised by the Registrar of Banks and the External Auditors. The Chairman of the bank's Audit Committee will be required to present on a selected topic.
- Prudential Meeting – Meeting with the CEO / MD, heads of risk management and Internal Auditor. It provides an opportunity to discuss the bank's strategic plan and budget with the CEO and each department, as well as raise issues that are of concern to the Registrar of Banks.
- Discussions for the purpose of getting explanations on trend data and the bank's strategic plan and budget.
- Site meetings – On-site meetings are conducted to verify the bank's asset quality – once every 24 months. If need be, on-site visits can be scheduled more regularly to address risk areas that are not well managed.

This schedule of meetings and site visits suggests regular and specialised disclosure to the Regulator. Banks also have to complete a number of prudential and risk-taking returns classified as DI (Deposit taking institutions) returns. The schedule for this disclosure is set out in Table 10.3.1. Each of the DI returns focuses on a different prudential aspect, with a total of 18 monthly returns, 2 quarterly returns, 4 half-yearly returns and 4 annual returns, some 236 returns in all. It is beyond the scope of this study to evaluate the requirements of these returns; nonetheless **the regularity and quality of these returns suggest significant disclosure requirements.**

While fiduciary duties are generally only to shareholders, it has been argued that bank holding companies have a fiduciary duty not only to shareholders but also more broadly to creditors (Macey & O'Hara, 2003). In this context the question may be raised to what extent disclosure to the regulator, who is seen to act on behalf of creditors, should be made public.

While some returns can be accessed for individual banks on the Reserve Bank website, in many cases only the aggregated data for all banks is available. Compliance with Basel II may enhance the potential role of market discipline as both disclosure to shareholders and risk management improves. As risk management becomes more sophisticated, banks are likely to spend more on improving their disclosure and risk management framework, not only because of Basel II, but because of what the market would expect of such sophisticated banks. If this is an incentive for improved disclosure, these standards may become market standards not only for Basel II compliant banks, but smaller banks and investment banks, which are likely to face lower requirements from Basel II.

The stability of the South African banking system suggests that the scope and efficiency of government intervention has been adequate. However, as Table 10.3.2 reflects, the industry has not been without instances of liquidation or takeover. Indeed since 1994, some 48 deregistrations or takeovers have taken place and 8 liquidations. These numbers suggest that while the Reserve Bank plays the role of lender of last resort, it still allows banks to fail. In terms of the potential moral hazard brought about by the role of lender of last resort, this suggests appropriate supervision.

The demise of the A2 banks, at the time of the SAAMBOU debacle, as well as the recent restating of Nedcor's balance sheet and earnings, has caused market commentators to reflect on the scope and efficacy of the disclosure by banks[4]. In the annual PWC Banking Survey conducted after the crisis, both domestic and foreign banks felt that the regulator could have been more proactive and that more could have been done by the press in informing the public (PWC, 2003, p. 23).

Standards for disclosure need to be regularly evaluated given the changing nature of banking.

[4] For example, refer to the Business Day and the Business Report commentary of 24 February 2004.

Table 10.3.1 Returns of Deposit Taking Institutions (DI returns)

	Bank Supervision - Local Bank Interests						Research requirements		
	Calender Year				Financial Year		Calender Year		
Form Number	Monthly 15 days	Monthly 20 days	Quarterly 20 days	Yearly	Half yearly	Yearly	Monthly 15 days	Monthly 20 days	Quarterly 20 days
	M1	**M4**	**Q1**	**Y2**	**H1**	**Y1**	**M3**	**M2**	**Q2**
DI 100	M1					Y1			
DI 110	M1								
DI 200	M1				H1	Y1			
DI 300	M1								
DI 310	M1								
DI 400		M4							
DI 402	M1								
DI 410	M1								
DI 420	M1								
DI 430	M1								
DI 500		M4							
DI 510		M4							
DI 520					H1	Y1			
DI 525	M1								
DI 600	M1								
DI 700			Q1						
DI 701					H1				
DI 702					H1				
DI 703				Y2					
DI 900							M3		
DI 910								M2	
DI 920									Q2
DI 930								M2	
Total category submissions	11	3	1	1	4	3	1	2	1

Source: Bank Supervision Department, South African Reserve Bank

Table 10.3.2 South African bank deregistration and failure

Reasons for deregistration	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**Totals**
Liquidated curatorship	1	1	0	1	2	1	0	1	1	**8**
Deregistrations, takeovers, acquisitions, etc.	1	2	4	6	4	1	7	9	14	**48**
Total	2	3	4	7	6	2	7	10	15	**56**

Source: Bank Supervision Department, South African Reserve Bank

10.4 DISCLOSURE TO SHAREHOLDERS

In the wake of corporate scandals such as that of Enron in the United States and Leisurenet in South Africa, governance and disclosure are becoming increasingly important issues. This is both as a result of increased shareholder activism and concern that poor governance can erode shareholder value. **It is becoming more and more apparent that banks have a fiduciary duty to shareholders and creditors and hence the broad stakeholder community, given their holdings of illiquid assets with liquid liabilities and given their broad public role** (Macey and O'Hara, 2003). In this and the next section, the role of corporate governance is discussed further.

Corporate governance in South Africa has undergone considerable revision with the release of the second *King Report on Corporate Governance* in 2002 (more commonly known as King II). Most large South African banks publicly subscribe to these principles. The guidelines of King II are not embodied in law but apply to JSE listed entities, banks and Public Finance Management Act entities (such as national government departments and parastatals).

Support for the King II guidelines has been growing in the wake of recent corporate governance scandals in financial services, such as the liquidation of Regal Bank (where fiduciary duty to shareholders had not been adequately exercised), and a controversial share option scheme for Nedcor executives (Nedcor now has a separate corporate governance office).

Table 10.4.1 below summarises the core principles of King II, which has been widely acknowledged as incorporating best practice on corporate governance internationally, including the seminal UK Cadbury Committee Report (which defined corporate governance as "the system by which companies are directed and controlled"). Compliance with the King Code (King I) became a listing requirement of the JSE in July 1995, but was poorly enforced. King I was therefore revised to incorporate local and international developments, emphasise growing interest in non-financial issues and recommend means of enforcing compliance. The areas of most significant change are risk management and non-financial matters.

An increased focus on corporate governance also reflects greater levels of shareholder activism (many of South Africa's banking shareholders are large institutions that have traditionally been fairly passive) and the growing concern that managers should represent shareholders' interests, with boards a central focus of corporate governance. Unsurprisingly therefore, King II has affected shareholder concerns about board composition, board committees (with especial focus on audit and remuneration committees) and board accountability. The board is encouraged by King II to engage constructively with institutional shareholders.

Corporate governance indicators of South Africa's biggest banks are compared to those of the United State's largest 200 top-tier bank holding companies (BHCs)[5] in Figures 10.4.1 to 10.4.2. The averages for the BHC and SA's big four banks are shown. South Africa's big banks are seen to perform slightly better than the American banks, on average. Nonetheless, averages can be deceiving and on an individual basis some of the banks do rather less well.

The comparisons suggest a range of interpretations of the optimal board size. Other than Nedcor, all are the figures are below that of the mean for United States BHCs (see Figure 10.4.1.)[6] Figures 10.4.2 to 10.4.4 show that while Nedcor has fewer outside directors, it has more board meetings and committees than the other banks. FirstRand scores lowest for number of board meetings and committees. These data show that the Big Four do not meet the King II requirements for number of board meetings (at least one a quarter is recommended by King II).

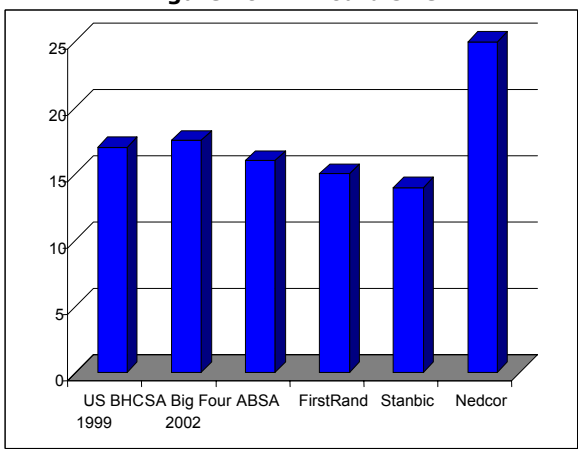
South African banks argue that their corporate governance structures are of a world-class standard in balancing power in decision-making, as well as in ensuring adequate assurance of risk management and internal control systems. Strides have also been made in encouraging greater representation of board members in terms of South African demographics, but this requires further progress to ensure adequate representation of previously disadvantaged South Africans. Standard Bank Group has a Transformation Committee, a particularly South African focus, while Nedcor has both Social and Environment and Corporate Governance Committees. These committees reflect an international and local emphasis on non-financial concerns.

Notwithstanding the emergence of a range of non-financial committees (such as those charged with transformation concerns), a relatively narrow, Anglo-American governance mould, which emphasises accountability to shareholders rather than stakeholders, is evident in the annual reports of South Africa's Big Four banks. (This will be discussed further in Section 10.5.)

[5] The BHC data were recorded in 1999, as quoted in Adams and Mehran, 2003, while the South African data are derived from the 2002 Annual Reports of ABSA, FirstRand, Nedcor and Standard Bank.

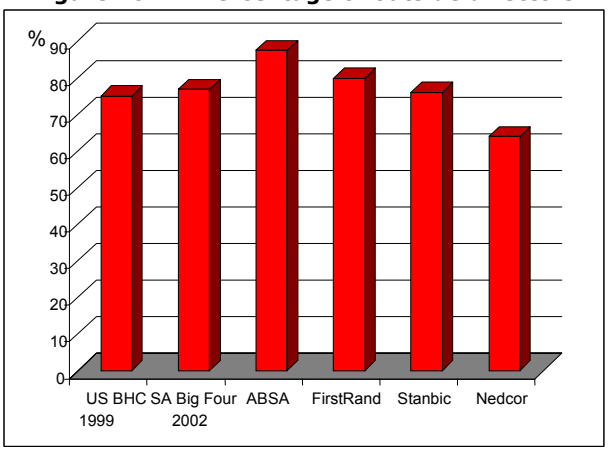
[6] At the restatement of its financial results for 2002, Nedcor announced it would be paring down its board form 25 to a more manageable 17.

Figure 10.4.1 Board size



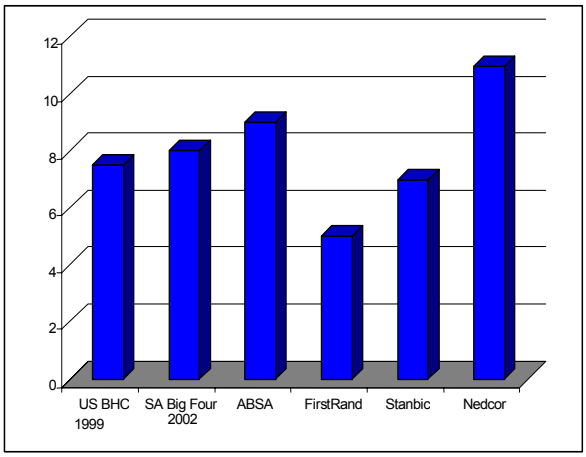
Source: Macey and O'Hara (2003) and local banks' Annual reports

Figure 10.4.2 Percentage of outside directors



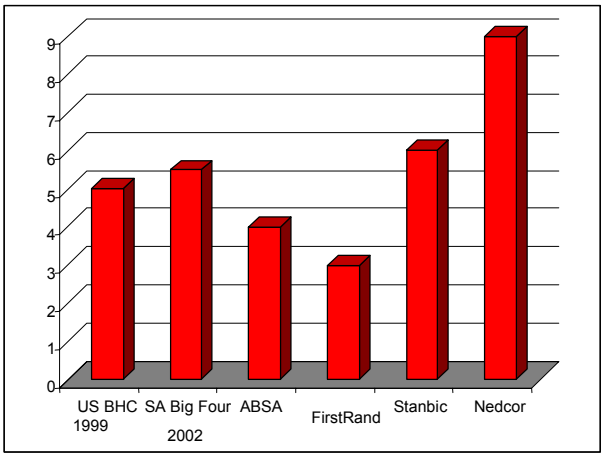
Source: Macey and O'Hara (2003) and local banks' Annual reports

Figure 10.4.3 Number of board meetings



Source: Macey and O'Hara (2003) and local banks' Annual reports

Figure 10.4.4 Number of board committees



Source: Macey and O'Hara (2003) and local banks' Annual reports

Table 10.4.1 Essence of King II (released March 2002)

Governance Criteria	Change from King I
Board of directors - focus on composition: there must be a distinction between the independent, non-executive chair and CEO and executive vs. non-executive directors	Revised focus area
Auditing and accounting - independence of external auditors must be assured, financial & non-financial reporting are important, a separate audit committee is emphasised	Revised focus area
Internal audit and risk management – risk-based approach recommended with director responsibility emphasised	Significant change
Non-financial matters - Based on triple bottom line (financial, environmental and social) concept; and a focus on shareholder activism (including active engagement with stakeholders)	Significant change
Compliance and enforcement - Companies Act quorum requirements should be met, as should standards for disclosure as well as transparency to financial media	Significant change

10.5 DISCLOSURE TO STAKEHOLDERS

Non-financial disclosure may increase, with greater compliance with international norms. Macey and O'Hara (2003) suggest this is more in line with a Franco-German model of corporate governance. On international exchanges, sustainability disclosure for large firms, including banks, is increasingly becoming a requirement for listing.

Investec's recent listing abroad provides a useful predictor of how this disclosure may emerge in the South Africa. Investec's second *Journey to Sustainability Report 2003* is a publication separate from the Annual Report and addresses transformation, employee, social and environmental issues, as well as the group's position on sustainability. The document also presents the bank's approach to BEE and employment equity. The report takes into account the reporting frameworks provided by KPMG's Sustainability Scorecard, King II and the Global Reporting Initiative (GRI).

Standard Bank Group's Annual Report applies a number of local and overseas indicators. These include:

- GRI indicators.
- The Edward Nathan and Friedland Sustainability Index.
- The Corporate Footprint (social and environmental) ratings.
- The Dow Jones Sustainability World Index (DJSI World 2003) ranking.

The bank's performance in terms of the DJSI measure is shown in Figure 10.5.1. The bank scored above the global industry average, but below the best company benchmark, performing better in the economic and social dimensions than in the environmental dimensions.

These ratings are important because they have been independently verified. The DJSI compares international financial products based on corporate sustainability criteria (strategies creating long-term shareholder value). In terms of financial services this has to do with strategies that ensure market potential are addressed by sustainable products, and the management of costs and risks.

Table 10.5.1 compares non-financial disclosure in terms of King II by South Africa's major banks, including Investec.

FirstRand is the least advanced in engaging stakeholders, demonstrating no social or ethical responsibility beyond corporate social investment (CSI) and disclosing no performance in terms of financial, as well as social and environmental, criteria (triple bottom line). ABSA and Investec, by contrast, are the most advanced in terms of triple bottom line and social/ethical responsibility reporting, while Standard Bank and Nedcor are making progress on non-financial reporting. Movement to greater levels of non-financial reporting by South Africa's larger banks is important in the light of the fact that KPMG's 2002 survey of the finance, insurance and securities sector found disclosure on sustainability issues in only half of the annual reports.

The banks' non-financial reporting can be assessed in terms of international benchmarks for socially responsible reporting. These include:

1. Completeness of all areas of activity in accounting (beyond financial issues).
2. Comparability with previous periods or benchmarks.
3. Inclusivity of all stakeholders in reporting.
4. Regular conduct of audits.
5. Embedding auditing within operations.
6. Disclosure or findings.
7. External verification of audits.
8. Continuous improvement.

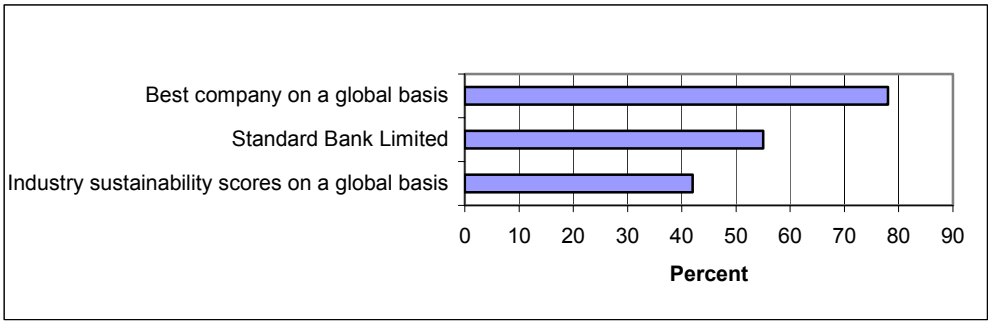
A description of each of these criteria and the evaluation of South African banks is given in Table 10.5.2. Apparent areas of weakness in terms of the sector evaluation include completeness, comparability and external evaluation, relative to external benchmarks.

It should, however, be recognised that most banks are only starting to report on these issues. It will take time to meet international benchmarks, which are, in any event, met by only a few international banks[7]. There is increasing evidence that South African stakeholders are becoming more responsible. The transformation of South Africa's economy to represent a broad base of South African interests is driven both by increased shareholder activism (for instance by the Public Investment Commissioners, PIC), as well as by general, political pressure to implement Black Economic Empowerment (BEE).

Given the market capitalisation of South Africa's banks, empowerment holdings are negligible. (Transformation is framed by the drafting of the Financial Services Sector Charter.) The charter has objectives such as the use of procurement to support BEE, increased access to finance for all South Africans and the transfer of ownership to previously disadvantaged South Africans. The charter is a private-sector initiative and has been designed to pre-empt government legislation. **Increasingly, disclosure to stakeholders is becoming a mechanism by which the public evaluates whether or not the banking system is meeting its social and financial goals. Such disclosure serves to counteract the excesses of market power.**

[7] For instance, in the UK, only ten banks are members of the UK Social Investment Forum (UKSIF), and of these, only half describe their socially responsible activities on the UKSIF website.

Figure 10.5.1. Standard bank and the Dow Jones Sustainability World Index 2003



Source: Standard Bank Annual Report 2003

Table 10.5.1. Non-financial Disclosure by South African banks

	ABSA	First Rand	Investec*	Nedcor	Standard
Stakeholder engagement	Y	N	To be extended	N	N
Social/ethical responsibility	Y	Y (CSI)	Y	Y	Y
Triple bottom line	Y	N	Y	Partial	Y
**Only SA bank with a separate Sustainability Report - ranked 10th by KPMG 2002 Survey of Sustainability Reports*					

Source: Evaluation based on banks' annual reports

Table 10.5.2. Benchmarking SA banks in terms of socially responsible reporting

"Eight Principles" of socially responsible reporting*	Major South African banks
Sector disclosure of sustainability issues in latest annual reports as per KPMG survey (of finance, insurance and securities)	50%
1. Completeness - the unbiased inclusion of all appropriate areas of activity in the accounting process.	N - focus on financial returns
2. Comparability of an organisation's performance with (i) that of previous periods, or (ii) external benchmarks.	N - too early
3. Inclusivity - appropriate dialogue with all its stakeholders.	Very little
4. Regularity and evolution - periodic preparation of accounts and conduct of an audit at appropriate times.	N
5. Embeddedness - incorporation of accounting processes, consultation and audit findings within operations.	N - typically separate exercise, if conducted
6. Disclosure - communication to one or more of an organisation's stakeholders of reports, audit processes and statements.	Generally limited to shareholders
7. External verification of records, process, reports or statements by an independent third party.	N - although Standard Bank's ranking DJSI 2003, sets it apart
8. Continuous improvement in relation to values and objectives of stakeholders and broader social norms.	Gradual consideration evident
* As described in Gonella, Pilling and Zadek (1998).	

Source: Local banks' annual reports

Chapter 11

The legislative and regulatory environment

This chapter consists of the following sections:

1. The primary objectives of international banking and payment system regulators.
2. The impact of banking and other legislation on competition.
3. International trends in payment system legislation.

and the following appendix:

1. International reports related to the regulation of payment systems.

The case for regulation of the banking industry was set out in Chapter one. While stability remains the *sine qua non* of such regulation, closer examination reveals that the regulatory environment differs from country to country. The aim of this chapter is to examine these differences and relate them to the South African regulatory regime.

The findings and conclusions are:

- The obligation to maintain a supervisory and regulatory environment that encourages innovation and competition is given prominence in the objectives of the banking regulators of countries such as the US, UK and Australia.
- Such an obligation ensures that the regulatory agencies assess the impact of their actions on competition and innovation in the banking and broader financial sector. Without such an obligation, an excessively conservative regulatory approach may be followed, motivated by stability and safety concerns, which may result in an unduly restrictive environment.
- The maintenance of a competitive environment is not amongst the stated objectives of the South African banking and payment system regulators. The Task Group recommends that the objectives of the regulatory agencies should be expanded to include a requirement to assess the impact of their actions on competition.
- Certain aspects of the Banks Act and other legislation have curtailed the level of competition. This includes aspects such as the level at which the initial capital requirement is set (R250 million), extreme limitation on non-bank competitors' ability to raise loan capital and preferential treatment of banks in certain other legislation.
- The impact of payment system arrangements on competition has received considerable international attention in recent years and a number of countries have introduced changes to legislation and governance arrangements, in order to improve the level of competition and contestability in this area.
- While the South African payment system regulators have begun the process of reviewing standards and governance, an evaluation in terms of international benchmarks should be undertaken.

11.1 THE PRIMARY OBJECTIVES OF INTERNATIONAL BANKING AND PAYMENT SYSTEM REGULATORS

The regulatory agencies in the United States of The regulatory agencies in the United States of America give prominence to the promotion of competition, as can be seen in Table 11.1.1.

For instance:

- The first objective of the Federal Reserve relates to financial soundness and prudential risks, while the second deals explicitly with various aspects of achieving a competitive environment: *"And second, to maintain a supervisory and regulatory environment that encourages innovation and efficient competition in financial services and that does not require excessive risk-taking by banks in order to generate competitive returns*." (See Table 11.1.1 and Table 11.2.1.)
- In respect of the Office of the Comptroller of the Currency, the primary objective is similarly "… *to* ensure a safe, sound*, and competitive* banking system", and the Office of Thrift Supervision is required to "… supervise saving associations … in order to maintain their safety and soundness and compliance with consumer laws, *and to encourage a competitive industry".*

The responsibility for competition matters in the UK lies with their Competition Commission (see Box 11.3.3). However, the FSA has to consider the efficiency, innovation and "*the value of competition between financial firms*"[1] in the pursuit of its primary regulatory objectives (see Table 11.1.1).

Furthermore, the Office of Fair Trading (OFT) is responsible for an ongoing review of the 'rules and practices' of the Financial Services Authority (FSA) and others. "*If [the Director General of the OFT] considers that any of the rules or practices have a significantly adverse effect on competition, he must make a report, which is sent to the Treasury, Competition Commission and FSA*."[2] Australia has a similar requirement for the competition authorities to review the impact of all legislation on competition[3].

In the European Union, competition issues in respect of banks and banking services could be affected at two levels:

- Through the competition legislation, where the European Competition Rules are geared at (a) co-operating parties that obtain substantial market power, or (b) rules directed at public authorities, where the concern is with practices that may distort competition.
- In specific EU Directives, which sets rules on disclosure and relevant business practices[4].

The relationship between the Competition Commission in South Africa and industry regulators is similar to that in the UK and Australia, except that it is possible for the Minister of Finance to issue a notice to exempt a bank from a competition investigation. It does not appear that the industry regulators in South Africa have duties similar to those of their US, UK or Australian counterparts, either in promoting competition or in considering the impact of their regulatory actions upon the competitive environment.

While the vision of the South African Reserve Bank (see Table 11.1.1) refers to effective competition, its mission and statement of functions does not. The maintenance of financial stability remains its primary goal.

The objectives of the banking and payments system regulators in South Africa should be reviewed in order to evaluate the possible introduction of formal objectives to maintain a competitive environment.

[1] The single regulator for the financial services industries in the UK. Their regulatory mandate thus includes bank supervision.
[2] See OFT Web site, http://www.oft.gov.uk.
[3] The Competition Principles Agreement requires that legislation should not restrict competition unless it can be demonstrated that the benefits to the community as a whole outweigh the costs of such restriction(s), and that the objectives of the legislation can only be achieved by restricting competition (NCP Review of the Consumer Credit Code, 2001, p 9).

[4] The rules that govern the pricing of e-money services (the 'E-Money Directive, 2000/46/EC), or the 'Code of Conduct' on electronic payment (Directive 87/598/EEC) determine that the 'scale of charges' requires fair access and pricing that does not restrict competition.

11.1 THE PRIMARY OBJECTIVES OF INTERNATIONAL BANKING AND PAYMENT SYSTEM REGULATORS

Table 11.1.1. Mandates of international banking regulators in terms of banking competition
United States of America
Federal Reserve: "First, to promote and enforce sound practices so that banks do not present unacceptable threats to U.S. or world financial markets or impose unacceptable costs on the insurance funds and, ultimately, the U.S. taxpayers. And second, to maintain a supervisory and regulatory environment that encourages innovation and efficient competition in financial services and that does not require excessive risk-taking by banks in order to generate competitive returns.[5]"
Federal Deposit Insurance Corporation: "FDIC preserves and promotes public confidence in the U.S. financial system by insuring deposits in banks and thrift institutions for up to $100,000, by identifying, monitoring and addressing risks to the deposit insurance funds; and by limiting the effect on the economy and the financial system when a bank or thrift institution fails[6]".
Office of the Comptroller of the Currency: The office of the Comptroller of the Currency (OCC) charters, regulates, and supervises all national banks. The OCC's activities are predicated on four objectives that support the OCC's mission to ensure a stable and competitive national banking system. The four objectives are: • To ensure the safety and soundness of the national banking system. • To foster competition by allowing banks to offer new products and services. • To improve the efficiency and effectiveness of OCC supervision, including reducing regulatory burden. • To ensure fair and equal access to financial services for all Americans.
Office of the Thrift Supervision Supervise savings associations and their holding companies in order to maintain their safety and soundness and compliance with consumer laws, and to encourage a competitive industry that meets America's financial services needs.
European Union
European system of central banks[7]: The primary objective of the Eurosystem is to maintain price stability.[8] The ESCB act in accordance with principle of open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Treaty.
UK
FSA: The FSA aims to maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal.[9] "The FSA's objectives are: To maintain confidence in the UK financial system; To promote public understanding of the financial system; To secure the right degree of protection for consumers; To help reduce financial crime. While working towards these objectives, we bear in mind: (1) the need to use resources in the most economic and efficient way; (2) the responsibilities of the management in regulated firms; (3) the need to balance the burdens and restrictions on firms with the benefits of regulation for consumers and the industry; (4) the need to allow innovation; (5) the international character of financial services and markets and the UK's competitive position; and (6) the value of competition between financial firms."
Australia
Payments System Board: The objectives of the Board are: "To control risk in financial system; To promote the efficiency of the payments system; To promote competition in the market for payment services[10]."

Table 11.1.2. Mandates of South African Regulators
South African Reserve Bank: **Mission:** The primary goal of the South African Reserve Bank is *"the achievement and maintenance of financial stability".* ***Vision:*** The South Africa Reserve Bank is convinced that it is essential that South Africa has a growing economy based on the principles of a market system, private and social initiative, effective competition and social fairness. It recognises, in the performance of its duties, the need to pursue balanced economic development and growth. **Functions:** The Reserve Bank, in the pursuance of its goal, the realisation of its philosophy and the fulfillment of its responsibilities, assumes responsibility for: (1) formulating and implementing monetary policy in such a way that the primary goal of the Reserve Bank will be achieved in the interest of the whole community that it serves; (2) ensuring that the South African money, banking and financial system as a whole is sound, meets the requirements of the community and keeps abreast of developments in international finance; (3) assisting the South African government, as well as other members of the economic community of southern Africa, in the formulation and implementation of macroeconomic policy; and (4) informing the South African community and all interested stakeholders abroad about monetary policy specifically, and the South African economic situation in general.
Bank Supervision Department:
National Payment Systems Department: Overall management and oversight function of the National Payment System (NPS), with the objective to provide for the management, administration, operation, regulation and supervision of payment, clearing and settlement systems in the Republic of South Africa; and to provide for connected matters.

[5] Website *www.federalreserve.gov.uk*
[6] Website http://www.fdic.gov.uk/
[7] Composed of the European Central Bank (ECB) and the national central banks (NCBs) of all 15 EU Member States.
[8] Without prejudice to this objective, the Eurosystem "shall support the general economic policies in the community and act in accordance with the principles of an open market economy also to achieve the objectives of the Community as laid down in Article 2 of the Treaty".
[9] Website: *www.fsa.gov.uk*
[10] Payment System Act 1998 and the Payment Systems and Netting Act 1998

11.2 THE IMPACT OF BANKING AND OTHER LEGISLATION ON COMPETITION

Banking and payment system legislation frequently have an impact upon competition. Other legislation, such as the Usury Act and the Alienation of Land Act among others, may have a similar impact.

Some of the legislative provisions that affect the level of competition in banking, include:

- Minimum capital requirements.
- Cost of bank registration; annual compliance cost.
- Existence of deposit insurance.
- Definition of deposit and exemptions thereto
- Usury Act requirements (ledger fees; home loans).

South Africa's minimum capital requirements, at R250 million, are high by international standards. This limits entry and competition. The legislation thus prescribes a minimum size for banks and creates a severe disincentive for the establishment of small regional or niche banks. The cost of registering a bank and the annual compliance cost also affect the level of competition. Bankers frequently complain about the high compliance costs and other company legislation[11], something that the Registrar of Banks has also publicly acknowledged (Business Day, 2003, "Money Laundering Laws Impossible", 12 Dec).

If a deposit insurance scheme exists, it is easier for smaller banks to compete with large banks. Deposit insurance reduces depositors' fear of failure of small banks and levels the playing field between small and large banks. Deposit insurance schemes always have to accommodate the risk that the existence of the guarantee will lead to excessive risk-taking by owners. These trade-offs are extensively covered in the literature on deposit insurance schemes.

The level of competition in credit extension, between bank and non-bank finance companies, is reduced by the wide scope of the deposit taking definition that covers most debt instruments and the very narrow definition of the exemptions. The restriction of access to the payment system to registered banks also acts to restrict competition. While this regulation is necessary for large value payment schemes, transparency of scale of charges, fair access to electronic payment and non-restrictive contracts are specific regulations which promote competition (or inhibit anti-competitive practices) in other jurisdictions. (See Box 11.2.1.) There is thus a severe limitation on non-bank finance companies' ability to raise loan capital, inhibiting competition in credit extension from outside the banking industry[12].

Other legislation also provides for special treatment of banks. This includes the treatment of certain bank fees in the Usury Act, allowing banks to charge rates higher than the Usury Act limit.

The exemption for entities that do not solicit for deposits and do not accept deposits on a regular basis is limited to 20 contributors and an aggregate of R500 000. The corporate paper exemption, on the other hand, has a very high entry requirement. The combined effect of these definitions is that the financing of ventures through debt instruments is severely hampered. (Banks Act 1990, as amended to 2000; definitions.)

Any new legislation should avoid undermining competition and inhibiting innovation. Existing legislation and any future legislative changes should be evaluated to ensure that they do not inhibit competition inappropriately. A review of legislation from this point of view was outside the scope of the Task Group's Terms of Reference. However, the Task Group believes that there is sufficient evidence to justify such a review.

[11] A detailed comparison of the compliance cost with other dispensations is outside of the scope of the Task Group.
[12] FEASibility, 2003a.

Box 11.2.1 Specific regulations to promote competition, or limit anti-competitive practices
(Illustrative list)

- Any scale of charges (regarding electronic payments) must be determined in a transparent manner, taking account of the actual cost and risks and without involving any limitation on competition [EU Directive 87/598/EEC, III (1) c].
- Traders must be able to choose which point of sale terminal they wish to install… [EU Directive 87/598/EEC, III (3) c].
- Contracts (regarding data protection in respect of electronic payments) must not restrict traders freedom of operation or freedom to compete [EU Directive 87/598/EEC, III (4) d].
- Irrespective of their economic size, all service establishments … allowed fair access to the system of electronic payment [EU Directive 87/598/EEC, III (1) c].
- To promote mutual access among different card system … no exclusive trading clauses [EU Directive 87/598/EEC, IV (1) a].
- Contracts with traders must admit effective competition between different issuers [EU Directive 87/598/EEC, IV (1) b].
- Following an investigation into potential anti-competitive practices in interchange fees and membership requirements, credit card schemes have been brought under the regulatory oversight of the Australian Central Bank. This is the first step in establishing standards and access regimes. Membership had been restricted to authorised deposit-taking institutions and this was found to be "more restrictive than necessary to protect the safety and integrity of the systems". [Media Release, Reserve Bank Australia, 12 April 2001.]

11.3 INTERNATIONAL TRENDS IN PAYMENT SYSTEM LEGISLATION

Both the UK and Australia conducted major reviews of their payment system arrangements in recent years, covering the impact of payment system arrangements and practices on competition. Both countries introduced legislative and regulatory changes as result of these reviews. A list of recent reviews of international payments systems is provided in Box 11.3.1. Comment from the Bank of England regarding payment systems and public policy is contained in Box 11.3.1.

Authoritative international bodies on policy and legislative issues in respect of payment system regulation have concluded that central banks should address legal and regulatory impediments to market development and innovation (see Box 11.3.2) and that non-banks may play a positive role in retail payments (BIS, 2002, see Box 11.3.4.)

The Task Group makes the following observations from the review of these documents:

- There are potential trade-offs between systemic risk and competition in the regulation of payment systems. While low-value retail payment systems generally pose *limited systemic risk* they have *significant impact upon competition and efficiency*[13].
- Many countries limit access to payment systems to banks. However, both the EU and BIS recognise the increasing participation of non-bank service providers in retail payment services, and the role that of non-bank participants play in increasing competition[14] (see Box 11.3.4).
- There is an increasing recognition that there are substantial differences between the risks associated with deposit taking (i.e. conventional banking risks) and the risks associated with the provision of payment services. The EU responded by issuing a Directive on E-Money[15], thus creating a separate prudential regime for non-bank entities that are engaged in the provision of electronic payment services (including minimum entry requirements, capital requirements and supervisory standards in respect of such entities).
- Market access for payment service providers, competitiveness and contestability are broadly recognised as necessary to ensure that the benefits of innovation and economies of scale feed through to end users.
- There is a recognition of the need for "co-operation agreements" between participants in order to provide payment services. Such agreements, however, can give rise to anti-competitive practices[16].
- The following are recognised as important policy objectives in the regulation of retail payment systems:
    - Efficiency.
    - Security & safety.
    - Competition: access to markets & level playing field.
    - Removal of legal & regulatory barriers to innovation.
    - Consumer protection.

The Task Group recognises that progress has been made by the Payment System regulators in South Africa in reviewing the payment system structure and governance in the light of changes in market profile. However, it is not clear that the issues listed above have received explicit attention in these reviews, or that they had been addressed.

This Report indicates that the costs related to the payment services make a substantial contribution to the high cost of banking services[17]. It is important that steps be taken to ensure that the policy objectives for the regulation of retail payment systems – as identified above - are explicitly reflected in the payment system legislation (particularly, with regard to competition and consumer protection).

The Task Group recommends that a formal assessment should be done of the current payment system legislation[18], and of the regulatory arrangements (including the role of PASA), in comparison with the international benchmarks in order to identify and address any shortfalls.

[13] BIS, Policy Issues, p6; Bank of England, 2000, p7, 8.
[14] Policy Issues for Central Banks in Retail Payments, BIS, 2002: p1, p27, p29; EU Consultative Document (COM (2003) 718 final): p10, p12, p22 (footnote 33); E-money Directive; UK payment systems: An OFT market study of clearing systems and review of plastic card networks. May 2003, Executive Summary, various references.
[15] Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions.
[16] Van Miert, 1998.
[17] There is reason to believe, in the words of the BIS Report, 'that the benefits of scale and technological innovation are not passed through to consumers', due to weaknesses in the competition environment.
[18] The Task Group takes note that pending payment system legislation goes some way to addressing their concerns regarding competition.

Box 11.3.1 Bank of England
Oversight of Payment Systems (2000) - extract

Payment systems and public policy

Payment systems give rise to public policy issues in three main areas.

The **first** relates to the structure of payments systems, their relationship with their members and the implications for the stability of the financial system as a whole.

A **second** area is a concern for the efficiency and effectiveness of the UK's financial sector both domestically, in serving the needs of the UK economy, and internationally, in terms of the attractions of the UK as a place to do financial business. Working with market participants, the Bank aims to promote improvements in the UK payment and settlement infrastructure for the benefit of members and end-users. The Bank generally seeks to support market-led development but may, where necessary, take a more active part in catalysing market initiatives or assume an operational role.

The **third** area is competition policy, where, as with other significant components of the economic infrastructure, there is a public policy interest in ensuring that a competitive environment exists and that any competitive abuses are curbed. Competition issues are the primary responsibility of the competition authorities, not the Bank, however the Government, in response to Cruickshank's report confirmed its intention to introduce legislation to foster competition in the payments business and to consult on specific proposals.

Box 11.3.2 Bank for International Settlements
Policy issues for central banks in retail payments (2002)

Legal and regulatory framework

Public Policy Goal A: Policies relating to the efficiency and safety of retail payments should be designed, where appropriate, **to address legal and regulatory impediments to market development and innovation.**

The central bank should, at a minimum:

(i) Review the legal and regulatory framework to identify any barriers to improvements in efficiency and/or safety.
(ii) Cooperate with relevant public and private entities so that the legal and regulatory framework keeps pace with changing circumstances and barriers to improvements in efficiency and/or safety are removed, where appropriate.

The range of possible additional actions could include, depending on the individual central bank's responsibilities, powers and priorities:

– Altering regulations that currently present barriers to improving efficiency and safety, where this is within the central bank's remit and where other public interest arguments do not militate against such action.
– Introducing or proposing new regulations, as the central bank's remit allows, where the legal or regulatory framework is insufficient to support increased efficiency and/or safety.
– Offering expert advice to other responsible authorities, for example in the preparation of relevant legislation.

Box 11.3.4 Bank for International Settlements - Established retail instruments 2002 - extract

Established retail payment instruments

Non-banks have become involved to a limited extent, particularly in Australia, Canada and the United States in traditional non-cash retail payment instruments. For example some non-bank financial institutions that provide investment or credit accounts to users, such as investment funds and insurance firms – or even retailers with proprietary credit operations – allow their clients to make payments to third parties using cheques or payment cards. In some other countries, for example Germany, the regulatory regime restricts the provision of payment services to banks. Some general purpose credit card associations, such as MasterCard, permit non-bank financial institutions to be card-issuing members and payment acquirers, although they are required to settle payments through a bank.

Innovative services

Non-banks are involved in some of the innovative services described in Section 4.2. Banks have been the principal participants in the most prominent e-money arrangements, but in many instances non-bank financial institutions have also participated as card issuers and value providers. In some instances, even non-financial institutions have established e-money arrangements, although to date these have remained limited purpose instruments. EBPP service providers include non-bank financial and non-financial institutions. Some payment portals and other "consolidators" (intermediaries between payers, payees and their account-holding institutions, providing access to retail payment services in combination with payment transmission, accounting and processing services) are exclusively linked to a particular bank, but many have arrangements with several banks.

The developing roles of consolidators and payment portals in EBPP arrangements and internet shopping, of payment acquirers in ATM and debit card networks, of non-bank card issuers in credit card networks and of non-bank card issuers and value providers in e-money schemes have made the line between the direct provision of retail payment services to end users by non-banks and the provision of related support services to users and payment providers much less clear than in the past.

There is a spectrum of relationships involved. At one end are relationships that can be viewed clearly as outsourcing. Thus, the bank, or non-bank financial firm, provides the end-user with a deposit account from which payments are sent and received, as well as access to clearing and settlement arrangements for the payment items. Payment transmission (including authentication and authorization), processing and accounting are outsourced to non-financial institutions, which are sometimes established as joint ventures of the financial institutions and sometimes are independent service providers. Further along the spectrum, a non-bank contracts with a number of deposit-taking institutions to provide this service to their account holders, as well as with merchants. In these instances, the non-bank is a direct provider of payment services in end-user markets but must access clearing and settlement services through a member bank or non-bank financial firm. Further along still, the non-bank contracts directly with the end-user for the provision services, aggregates payments in its own books and makes aggregate payments to the final recipient in direct competition to services offered by banking institutions.

Cross-border provision

Non-banks also have a significant market share in some specifically cross-border instruments such as wire transfers, traveller's cheques and money orders. Western Union and MoneyGram are prominent in this market worldwide. Some non-bank providers of innovative services operate extensively in a cross-border as well as domestic context.

Provision of payment security services

Some non-banks provide services that are related to retail payments and critical to their security, in particular certification services. Providers of certification services are, in many instances, not financial institutions.

APPENDIX: 11.1 INTERNATIONAL REPORTS RELATED TO THE REGULATION OF PAYMENT SYSTEM

International reports related to the regulation of Payment Systems
• The supply of banking services by clearing banks to small and medium-sized enterprises, Competition Commission, UK, March 2002. • Competition In UK Banking, Don Cruickshank (chair), 2000. • Oversight of Payment Systems, Bank of England, November 2000. • UK payment systems: An OFT market study of clearing systems and review of plastic card networks, Office of Fair Trading, UK, May 2003. • Financial System Inquiry Final Report, Australia, Stan Wallis (chair), 1997. • Clearing And Settlement Arrangements For Retail Payments In Selected Countries, BIS, 2000. • Policy Issues For Central Banks In Retail Payments, Committee On Payment And Settlement Systems, BIS, 2002. • Core Principles For Systemically Important Payment Systems, BIS, 2000. • Payment and settlement systems in selected countries, BIS, April 2003. • EU DIRECTIVE on the taking up, pursuit of and prudential supervision of the business of electronic money institutions, Directive 2000/46/EC, September 2000. • EU Consultative Document on a New Legal Framework for Payments in the Internal Market, December 2003. • Evolution In Banking Competition (US), Varvel & Wallich, Economic Review, March/April 1981. • Regulation and Competition in German Banking: An Assessment, Fischer & Pfeil, Center for Financial Studies, Johann Wolfgang Goethe-Universität, 2003.

Chapter 12

The way forward: conclusions and recommendations

The chapter consists of the following sections:

1. The Task Group's vision for the South African banking system and the framework of the analysis.
2. Assessment of the competitiveness of the South African banking Sector.
3. Further elaboration of the recommendations of the Task Group.
4. Prioritisation and complementarity of the recommendations.
5. Conclusions and further research.

and the following appendix:

1. Reflections on the proceedings of the Task Group Seminar

The recommendations of the Task Group are as follows:

i. Government should introduce improved disclosure requirements on banking services.
ii. Government should introduce legislation that would compel banks to offer existing and potential customers unbundled service and pricing options.
iii. Penalty fees, charges for essential services or charges for services not open to competition should be on a cost-plus basis and open to regulatory oversight.
iv. Compliance by banks of the pricing disclosure requirements should be monitored.
v. Sharing of client information (with client consent) should be common practice, to lower information barriers to entry into banking and switching between banks.
vi. Government should pass enabling legislation for second- and third-tier banks.
vii. While greater access to financial services is to be welcomed, a National Bank Account defined in terms of price-fixing and collusion or a subsidy to one or more of the big banks is likely to have anti-competitive implications and should be avoided.
viii. Government should investigate the feasibility of transforming the Postbank into a state-owned bank that can effectively provide deposit taking and electronic transmission facilities to the lowest-income groups and the unemployed.
ix. Government should promote entry of and competition by foreign banks by addressing capitalisation requirements.
x. The principles of interoperability in the payments system and the transparency of access requirements to the payments system should be extended. Access by second-tier banks to the payments system on competitive terms should be facilitated.
xi. Government should investigate the feasibility of implementing an e-money directive enabling electronic transmission facilities by suitably regulated non-banks.
xii. The concept of *complex monopoly* (as defined by the UK Competition Commission in their enquiry into banking services for SMEs) should become part of the remit of the Competition Commission.
xiii. The Competition Commission should investigate the possibility of a *complex monopoly* in the governance and operation of the payments system.
xiv. Government should prohibit any preferential processing mechanism for payments.
xv. Government should establish a deposit-insurance scheme for all banks.
xvi. All bank and payment regulators should be required to consider the competitive impact of their regulation.

1. The Task Group's vision for the South African banking industry and the framework of analysis

The South African economy is sound and poised for further growth. At the same time, the banking system is stable, profitable and functions well for high-net-worth individuals and corporations. Since banks supply a crucial service for society at large and because bank failure may impose high direct and indirect costs on a nation, the Task Group is mindful that banks need protection against systemic failures in the financial system. However, there is no economic justification to exempt banks from competition policy in general. In countries such as the US, UK and Australia, where there is emphasis on the importance of effective competition in the banking sector, experience indicates that increases in competition and efficiency can be achieved without introducing instability in the banking sector.

It is for this reason that the Task Group considers South Africa's sound and profitable banking system to be an excellent foundation upon which to encourage conduct conducive to effective competition. Competition is important in all industries as it is a spur to efficiency, innovation, consumer choice, quality of goods and services, and low prices. If competition is weak these advantages may be lost and there is likely to be a transfer of welfare from consumers to both the producers of goods and services and the shareholders in these firms. Because of the central role of the banking system in the economy, the role of competition (and the costs of its impairment) are particularly important in banking. Disclosure to consumers should perform two functions: to enable them to evaluate the appropriateness of financial services for their needs and to enable them to compare appropriate financial services offered by different suppliers. Disclosure of this sort will enhance effective competition in the industry, so that fairness to all market participants and the efficient allocation of resources are achieved**.**

The market segment for lower-income earners and SMEs is generally under-served in South Africa. Low-income earners are usually confronted with high fees and charges and limited choice in terms of providers of basic banking services. The entry of second- and third-tier banks should allow competitors operating with radically different business models to enter the lower-income market.

South Africa is quite unusual in the structure of bank interest rates and charges. In the UK, for example, lending business tends to subsidise payment and transmission facilities; in South Africa, the payment and transmission services dominate and appears to cross-subsidise lending. This cross-subsidy is borne chiefly by low- and middle-income consumers and SMEs, rather than the more prosperous. High transmission and other charges also work against the access of poorer individuals to basic banking facilities, which undermines their access to the economy generally, increases their cost of living, and enhances their vulnerability. The private benefits of access to banking services include the ability to save and to build financial buffers against adversity, as well as reducing the costs associated with making payments. Social benefits (i.e. benefits for society as a whole) of access to banking services include reduction of theft, improved mechanisms for social transfers and other remittances (including tax and benefit remittances) and improved economic linkages to rural and deprived communities.

It is because of the existing lack of competition in the provision of basic banking services, itself an outcome of regulatory, structural and behavioural barriers to entry,

that the Task Group feels that any initiatives for a National Bank Account should not further entrench the existing pattern of banking or pre-empt competition. In particular, the terms of the National Bank Account should not make it difficult or unprofitable for new entrants to enter the market. Hence, a National Bank Account defined in terms of price-fixing and collusion and/or a subsidy to one or more of the big banks should be avoided. In addition, a National Bank Account should be defined to include electronic transmission facilities and should cater for the needs of small businesses, if it is to generate the social and private benefits of extension of banking services.

Current technology allows for new business models in banking, and while it is thought that the success of the second-tier banks will be associated with brand recognition, deposit insurance will also have a role to play. If deposit insurance were to be explicit and applicable to banks of all tiers, over time it may address the public perceptions which currently undermine small banks. Deposit insurance may also provide the foundation for the success of regional banks, which has the potential to address the needs of deprived communities and SMEs more effectively.

2. Assessment of the competitiveness of the South African banking sector

The Task Group identified a number of regulatory and structural weaknesses that currently undermine the level of competition in SA banking. The most important of these are the following:

- The entry requirements for banks in South Africa are high by international standards, particularly because there is no provision made for the establishment of second- and third-tier banking institutions.
- Disclosure of the cost of banking services is weak, as is the disclosure of the return on savings accounts, both of which undermine consumers' ability to compare the products of different institutions and thus competition. Poor disclosure is the result of weaknesses in the relevant banking legislation, consumer credit legislation and advertising rules. Under current regulatory arrangements, the banking code of conduct is administered by the Banking Council. There is no independent oversight of disclosure of interest rates or charges on savings accounts and transactions. Ideally disclosure rules should make it possible to compare bank and non-bank products (e.g. deposits versus money-market funds).
- The ownership of and control over the National Payments System, which constitutes essential infrastructure, is concentrated in the hands of the four biggest banks. It is possible that a *complex monopoly* exists, but a detailed investigation of this issue was not within the remit of the Task Group.
- There are a number of mechanisms in the payment-processing procedures through which preferences are created in favour of account-holding banks and related parties. These mechanisms undermine competition and create disincentives for both bank and non-bank competitors to enter into aggressive competition with the account-holding banks.

The Task Group considered a number of competitiveness indicators and concluded that:

- The market share of the four biggest South African banks is high, and while the Task Group could not find any evidence of any one bank acting as a monopoly, a detailed examination of their behaviour is such that it leads the Task Group to

conclude that collectively they behave as a *complex monopoly* (as defined in Appendix 1.2.).

- The Task Group concurs with the conclusion of the Wallis Report in Australia that a large number of suppliers is not a prerequisite for a competitive market, and that a competitive market may well be characterised by vigorous competition between a small number of suppliers. However, the lack of diversity in the banking sector is a matter of concern, and in particular the absence of second- and third-tier banking institutions. These sub-sectors appear to play a very important role in service delivery to low- and middle-income groups and SMEs in many developing countries as well as in most OECD countries.
- The returns on equity earned by the primary banks are high by international standards. However this is not the central focus of concern; indeed the Task Group finds that the sound and comfortable position in which banks find themselves provides an opportunity to introduce measures that will enhance accessibility and make competition more effective in the market.
- The leading banks' ability to maintain stable returns on equity over the business cycle does appear to indicate that the banks wield considerable market power. In particular, there are strong indications that the leading banks have considerable market power in maintaining a desired level of earnings from bank fees, and that the banks have been able to increase bank fees at will in response to any downward pressure on net interest income.

In terms of access and cost of banking services to different client segments, the Task Group came to the following conclusions:

- The high-income clients have a fair level of choice, partly owing to the availability of savings, loan and transmission substitutes, both from niche banks and from financial institutions outside the banking sector. For instance, insurance and unit trust products play a particularly important role in creating savings substitutes for the high-income population.
- Low- and middle-income earners face exceptionally high bank charges, low (and often negative) returns on savings accounts, and limited access to banking services. It is only in micro-lending that there are significant non-bank substitutes. The interest on these is often cripplingly high and the choice of terms is limited. Regulatory barriers and cost of payment processing are major factors in the high cost of these non-bank substitutes.
- The situation in respect of small- and micro-enterprises appears least satisfactory of all, with very limited access and very high costs.
- There is a substantial segment of the population which has no access to banking services. This segment may be divided into those who are ineligible for such services such as the informally employed or the unemployed and those who qualify by virtue of their low- to middle- income status. It is tempting to conclude that inadequate product design, weak service levels and high fees contribute to low- and middle-income consumers choosing to remain partially or fully unbanked, and the entry of second-tier banks, operating under different business models, may more adequately (and profitably) serve the needs of this group than do the big retail banks.

3. Further elaboration of the recommendations of the Task Group

The Task Group believes that the following changes should be considered in order to increase the level of competition and contestability in the South African banking system:

i. Government should introduce improved disclosure requirements on banking services, which should cover savings services, transmission services and credit services, and which should encompass point-of-sale disclosure as well as disclosure in marketing and advertising material.
ii. Government should introduce legislation that would compel banks to offer existing and potential customers unbundled pricing options. Each component of the service being offered should be separately priced and any discount on a bundle of services clearly indicated. This unbundling will facilitate price comparisons between service providers and allow consumers to make informed choices. Furthermore, consumers will be charged only for the service or transaction used and not for a package that may be inappropriate for their needs.
iii. Government should introduce legislation that regulates the charging of penalty fees, charges for essential services and charges for services not open to competition. Only fees that are related to actual costs or quantifiable risks should be charged to customers.
iv. Government should monitor the compliance by banks of the unbundled pricing disclosure requirements and undertake periodic evaluations of the impact of disclosure requirements on the effective functioning of the banking system.
v. Government should introduce legislation that will enable sharing of client information (with client consent) so that if consumers choose to switch their accounts, information barriers to switching will be reduced.
vi. Government should move away from the current monolithic bank legislation and should introduce a multi-tiered banking system, with second-and third-tier banks, at the earliest opportunity. The current requirements of the Banks Act are too onerous for specialised retail banks and undermine competition. The legislation that will enable the formation of 2nd and 3rd tier banks should be implemented as a top priority.
vii. A National Bank Account defined in terms of price-fixing or collusion and/or a subsidy to one or more of the big banks will pre-empt competition and should be avoided. In addition, if such a National Bank Account is defined without electronic transmission facilities for payments and/or if it excludes small businesses, it is likely to be inappropriate.
viii. Government should investigate the feasibility of transforming the Postbank into a state-owned bank that can effectively provide deposit taking and electronic transmission facilities, with a mandate that is limited to the lowest-income groups and the unemployed. The success of such an initiative is dependent upon a fundamental reorganisation of the Postbank, the transfer of accountability for the Postbank to National Treasury, and the introduction of a leadership group with a proven track record in the management of an institution such as the Postbank.
ix. Government should promote entry of and competition by foreign banks, potentially by adopting the EU approach in respect of home-country capitalisation for host-country branches as opposed to current arrangements which require foreign banks to establish a subsidiary or be separately capitalised.
x. The Task Group supports and wishes to see extended the principle of interoperability in the National Payments System and transparency of access currently being promoted by the National Payments System Department of the SA Reserve Bank. In addition, it would like to see full access of second-tier banks and the Postbank to the payments system on competitive terms.
xi. Government should investigate the feasibility of implementing a narrow e-money directive that would allow suitably regulated non-banks to take part in electronic

transmission facilities. This will not necessarily impose a new regulatory burden[1] on the authorities, as the definition of e-money can be restricted to small amounts, defined as pre-paid, carry insurance in the form of a percentage amount held in collateral and not paying interest. Such a definition of e-money would not necessarily carry systemic risk and would facilitate access to the benefits of formalised electronic transmission facilities for many consumers currently not served by the banks.

xii. The concept of *complex monopoly* should become part of the general remit of the Competition Commission. A *complex monopoly* occurs when firms, whether voluntarily or not and with or without agreement between them, so conduct their business that it prevents, restricts or distorts competition. This would give the Competition Commission scope to investigate anti-competitive behaviour even where it does not involve proven collusion.

xiii. The Competition Commission should investigate the possibility of a *complex monopoly* in the operation of the payments system.

xiv. Government should prohibit any payment processing mechanism that results in favouring any institution. The rules of the National Payment System regarding the processing order of payment instructions should be transparent. Accordingly, the rules should disallow any preferential treatment of payment instructions in favour of an account-holding bank.

xv. Government should establish a deposit-insurance scheme, which will enable smaller banks to compete on a more level playing field with the large banks in the field of retail deposit taking, and that may assist in preventing second- and third-tier failures leading to contagion. The successful introduction of a second- and third-tier banking component is dependent upon the simultaneous introduction of a comprehensive deposit-guarantee scheme.

xvi. Regulation has the capacity (whether intended or not) to impair competition. To guard against this, all bank and payment regulators should be required to consider the competitive impact of regulation. In addition, regulators might consider the impact on competition of existing legislation.

4. Prioritisation and complementarity of the recommendations

While the Task Group believes that all the recommendations are complementary to achieving the vision of a competitive, yet stable, banking environment, there are a handful of immediate priorities that have ease of implementation on their side. These are:

- Government should introduce improved disclosure requirements on banking services.
- Government should pass enabling legislation for second- and third-tier banks.
- Government should promote entry of and competition by foreign banks.
- Government should investigate the feasibility of implementing a narrow e-money directive enabling electronic transmission facilities by non-banks.

These recommendations are likely to have a beneficial impact on competitiveness, simply because the threat of entry can stimulate change as much as the realisation of such a threat.

[1] However, as indicated in chapter 11, the EU Directive on E-Money created a separate prudential regime for non-bank entities that are engaged in the provision of electronic payment services (defining minimum entry requirements, capital requirements and supervisory standards in respect of such entities)

The recommendations that are a priority for improving competition between the first-tier banks include improved disclosure, unbundling of products and sharing of client information to enable switching.

The priorities for second-tier banking include legislation to enable the operation of second and third tier banks, avoidance of the implementation of a National Bank Account that will pre-empt competition, the narrow e-money directive and deposit insurance.

5. Conclusions and further research

The Task Group concluded that:

- The lack of access and the high cost of banking services for employees in the low- and middle-income category are largely the result of weaknesses in the competitive environment, including high barriers to entry, lack of enabling legislation for second- and third-tier banks and onerous regulations such as FAIS and FICA.
- The lack of access to banking services for the lowest-income groups, particularly the informally employed and the unemployed, may have much less to do with deficiencies in the level of competition in banking. A lowering of the regulatory barriers to entry in order to accommodate the entry of second- and third-tier banks could improve access for this grouping in a major way, but even such an intervention is likely to leave considerable numbers of people without banking services. Therefore, special interventions may be required, such as provision of services through the Postbank, which then needs to be properly regulated as a second-tier bank.
- The high cost and lack of access to banking services for small and micro-enterprises may have more to do with a number of structural factors than to the level of competition in banking. These structural factors include the state of credit and insolvency legislation, price control through the Usury Act limit, deficient contract enforcement and limitations in respect of payment exposure information as well as credit information exchange.

Areas requiring further research include:

- An analysis of the capital markets, including the access of second and third tier banks to liquidity as well as the possible role of securitisation.
- A detailed study of rural and regional access to banking and electronic transmission facilities with a view to uncovering specific needs and any local monopoly, which exists.
- A detailed investigation into the feasibility of implementing a narrow e-money directive enabling electronic transmission facilities by non-banks.

Appendix 12.1

REFLECTIONS ON THE PROCEEDINGS OF THE
TASK GROUP SEMINAR

Held at National Treasury, Pretoria, 3rd of April 2004

By
David T Llewellyn

In these remarks I focus briefly on seven issues which, in one way or another, have been addressed by the Task Group:

1) The importance of competition in banking.
2) The profitability of South African banking.
3) The structure of pricing in banking.
4) Effective competition in banking.
5) The "unbanked" population in South Africa.
6) Banking and SMEs.
7) The potential role of foreign banks.

Before addressing these issues I should indicate that these issues are not unique to South Africa. In fact, in my own country (the UK) there have recently been three major official enquiries into competition in the British banking industry: two reports from the Competition Commission and a report from the Cruickshank enquiry. There are certain parallels between the UK and South African cases:

- Banking has been very profitable in recent years.
- Bank finance is particularly important for SMEs in the economy. In the UK, it was largely questions related to this that was the focus of two of the official enquiries.
- Banking is not a homogeneous business and we need to focus on sub-markets in which banks operate because: competitive conditions vary between sub-markets (e.g. wholesale versus retail business), contestability conditions are different, the profitability of different banking markets varies significantly, and because consumer behaviour is different in different markets.
- There appear to be substantial cross-subsidies inherent in the pricing (interest rates and charges) of different banking products and services.
- Limited role of foreign banks in retail banking business and banking for SMEs.
- In addition, in the UK, the Competition Commission found that with respect to SMEs, banking was characterised as a *complex monopoly* and for reasons which are very similar in South Africa.

While there are obvious major differences between UK and South African banking, some of the parallels are instructive.

Overall, South Africa has a very sound, sophisticated, robust and profitable banking sector and in many respects compares well with international experience. As in many countries, it is also a highly concentrated industry with four banks in particular being dominant. This may pose problems in some business areas.

Importance of competition in banking

The Task Group has been charged with investigating competition in South African banking industry. As an opening perspective, it is useful to consider why competition in the banking industry is a significant issue for any country. I view this at two levels. Firstly, the efficiency and stability of the financial system, but most especially of the banking industry, is important for the efficiency and development of the economy as a whole. There is substantial evidence from around the world indicating the importance of an efficient banking system for the economic development of a country.

Banking is not like any other industry because it impinges on all aspects of the economy. Secondly, there is also substantial evidence that competition in any industry including banking is a major spur to efficiency. Putting these two strands together demonstrates that competition in banking is an important issue for the general efficiency of the economy and the economic development of a country. This is most especially the case in those countries (including South Africa) where the banking industry is a dominant component of the financial system and

where many firms rely almost exclusively on banks for finance.

For all these and other reasons it is, therefore, appropriate to focus on the nature and degree of competition in South African banking and to consider whether there are limitations to competition that could be removed. The nature of any entry barriers (whether they be economic, structural, regulatory or behavioural) also need to be kept under review. Equally, how the competitive environment in which banks operates affects their own behaviour is an issue to be considered. Perhaps above all, any country needs to keep under review the possibility of significant market failures or market imperfections that compromise consumer welfare.

The efficiency of the banking system therefore has broader implications for the economy as a whole and competition contributes to efficiency. However, at the outset I focussed on efficiency *and stability* as ingredients of efficiency in the economy as a whole. While competition enhances efficiency there are some analysts who argue that competition may nevertheless compromise the stability of the banking system and that there is therefore a trade off between efficiency and stability through the route of competition. This is a very big and important issue. Suffice to say here that there is very little empirical evidence suggesting that increased competition necessarily compromises stability if effective and robust regulation and supervision mechanisms are in place. It is true that, in some countries, periods of substantial de-regulation and liberalisation in the banking industry have been followed by instability and, in some cases, financial crisis. However, this is usually because there were not corresponding changes in the prudential regulatory and supervisory regimes. Competition in and of itself is not a source of instability and the alleged trade off is largely illusory. However, this does emphasis the importance of effective regulation and supervision of the banking industry if competition in banking is to achieve its potential of enhancing overall economic performance.

The profitability of South African banking

By any standards, and as measured by rates of return on equity (ROE), South African banking has been very profitable in recent years. ROEs are amongst the highest in the world. This might suggest to some analysts that this is a product of a lack of competition. However, crude figures on profitability are misleading and a broader perspective is needed.

Firstly, strong profitability is essential in banking and possibly more so than in many other industries because of its systemic importance: there is no justification to be antagonistic to profitability in banking. Secondly, profitability may be a reflection of superior efficiency and this is appropriately rewarded. Thirdly, what is important is not ROE *per se* but *excess returns* (or Economic Value Added) which subtracts the cost of capital from ROE. In some industrial countries, for instance, banks appear to be profitable (in that they have positive ROEs) they are nevertheless not creating economic value in that their ROEs have been below the cost of capital. Germany and Switzerland are examples in recent years. While measured ROEs in South African banks is amongst the highest in the world, the cost of capital is also higher than in many industrial countries. Fourthly, while *excess returns* may be a reflection of lack of competition (the conclusion of the Cruickshank and Competition Commission enquiries in the UK) they may be desirable in banking because of the systemic importance of banks in the economy. Excess returns might be considered as a cushion for banking industry stability.

It is evidently the case that South African banks have been earning excess returns as defined above. The question is whether some part of these returns are unwarranted (and due to limitations in competition) and in excess of what is optimal for the economy as a whole taking into account all relevant factors such as systemic stability and the contribution that excess returns may make to this. The UK Competition Commission found that they were in the UK and a product in part of banks being in a *complex monopoly* situation. This, in my view, is a key issue for banks and public policy authorities to consider in South Africa. Further research is needed in this area.

The structure of pricing in banking

Rather than overall profitability, I would choose to focus on the structure of pricing that banks apply in South Africa. It is here that there may be issues to consider. A bank has three basic prices: the rate of interest on deposits, the rate of interest on loans, and the array of charges it imposes for particular transactions and services. The structure of these prices is a central issue in

banking and, in some senses, more significant then overall profitability. For maximum efficiency, and the minimisation of unwarranted internal cross subsidies between different products and services and between customers, the ideal conditions would be:

1) The interest rate on loans would reflect risk and would incorporate the true risk premium on all loans.
2) The interest rate on deposits would reflect market interest rates.
3) All charges would reflect the true cost of the service or product being provided.

If these conditions are not met some products and services will be under-priced relative to cost and risk (receive a subsidy) while others will be over-prices (subsidising). This is likely to produce a sub-optimal outcome and distribution of resources in the economy.

There are clearly trade-offs between these three sets of prices for the same overall profitability in that the structure can be changed in various ways to yield the same overall ROE. The balance of the three sets of prices could therefore be changed for two general outcomes:

1) To reduce any unwarranted excess returns (i.e. a transfer from shareholders to customers), and/or
2) To create a better structure of pricing by reducing cross subsidies but maintaining the same overall level of profitability (i.e. transfers between customers and products).

At various points in the Task Group report we suggest that there is a case for considering (2) in that the structure of pricing (and most especially the high level of some non-interest charges) is clearly sub-optimal. We find that charges in South African banking are both more extensive (covering a wider range of activities) and generally higher than in most other countries in the sample. We also find, for instance, that the net interest margin in South Africa is higher than in all our sample countries except Australia. Our judgement is that a more efficient allocation of resources would emerge from a more efficient structure of pricing. The ideal conditions outlined above are not in practice achievable with great precision. Nevertheless, they point in the direction in which change would be desirable. This does not in itself imply any view about the existence or otherwise of *excess returns*. It is motivated by optimality considerations. In particular, we judge that a more efficient set of prices would contribute beneficially in two areas: a reduction (though not necessarily substantially) in the size of the unbanked population, and to SME banking where charges seem in some cases to be very high.

Effective competition in banking

The report discusses three dimensions to competition: competition as conventionally understood, contestability and *effective competition.* The number of firms in an industry is not a true reflection of competitive pressures. In particular, the report gives emphasis to the effectiveness of competition in the market place. For competition to be effective, the consumer needs to be able to make rational decisions about the type of products and services to purchase and to be able to make rational choices between alternative suppliers. For the first requirement, the consumer needs to have relevant information about products. For the second, the consumer needs to have comparable information about products offered by different suppliers, and the transitions costs of switching between suppliers need to be reasonably low.

In the UK, the Competition Commission and other enquiries have found that there are impediments to the effectiveness of competition in some banking markets in that the consumer frequently does not have the information (e.g. about charges, penalties, etc.) necessary to make rational decisions about the purchase of products, information given by competing institutions is often not comparable and hence comparisons are difficult to make, and the practice of bundling of banking products and services means that the cost and price of components of the package are often not available.

These limitations to effective competition have lead to various public policy responses in the UK to ensure adequate disclosure. This needs to be considered in South Africa and in particular with respect to disclosure regime, the comparability of information, the transactions costs of switching accounts, etc, and several issues related to bundling.

The "unbanked" population in South Africa

The proportion of the population that does not have a bank account or easy access to banking services is particularly high in South Africa. This imposes both private costs (those imposed on the unbanked individuals) and social costs

(those that apply to society at large). The implication is that there would be both private and social benefits if the proportion of the unbanked population would be reduced. However, we need to consider the reasons for the high figure. In particular, a distinction needs to be made between *economic* reasons (such as low income and high risk of some potential customers, lack of information about potential customers, etc), and *behavioural* factors by banks. The latter relates to whether there are practices (that could be changed) of banks that deter some potential customers opening bank accounts and using banking services. There is not a great deal that, in the short run at least, can be done to address the former set of barriers. However, there is some limited scope (e.g. through a different structure of prices) to reduce the impact of the latter.

As there is a social benefit to be derived from extending banking services to a higher proportion of the population, there is a potential case for public policy intervention most especially in the low-value payments system and the development of the Post Office network for banking services.

Banking and SMEs

Small and medium-sized enterprises are often very important in an economy and often the source of innovation. In virtually all countries, SMEs are particularly dependent on banks for financing and other financial services. In many countries the issue has arisen as to whether SMEs are treated appropriately and fairly by the banks. In the UK, for instance, the Chancellor of the Exchequer commissioned both the Cruickshank group and the Competition Commission to investigate specifically whether SMEs were being badly served by the banking sector. In other words, questions related to banking and SMEs are not unique to South Africa and are not new.

As in the UK, SMEs in South Africa are dependent on a small number of banks as four banks have a commanding share of the market. There are also clear entry barriers not the least associated with information problems. The Task Group judges that in some business areas bank charges seem to be inordinately high. Again, the issue arises as to whether SMEs are being penalised through the structure of bank pricing. The issue of bundling of banking services is also potentially important in South Africa just as the Competition Commission found to be the case in the UK.

The potential role of foreign banks

In many countries, the entry of foreign banks has acted as a spur to competition and efficiency in local banking. It is evidently the case that foreign bank penetration is low in South Africa most especially with respect to retail banking and financial services and SME banking. While there are economic barriers, there seem also to be regulatory barriers operating in South Africa most especially with regard to the requirement that foreign banks are to be separately capitalised with South Africa and be structured as subsidiaries rather than branches. This is not the case in many industrialised countries where the principle of home-country regulation applies.

There is substantial empirical evidence in many countries that the presence of foreign-owned institutions has a significant potential to enhance the efficiency of the banking system. It can also improve the quality, pricing and availability of financial services both directly as providers of services and indirectly through enhanced competition. In many countries, foreign bank entry has been encouraged in order to weaken the market power of local banks.

As has been found in many countries, foreign banks can have a significant and beneficial impact on a local banking industry:

- Through enhanced competition and contestability.
- New expertise and experience.
- Different business practices.
- Financial innovation.
- Inducing capital inflows etc.

For these reasons, consideration should be given to ways of encouraging more foreign banks to enter the South African market.

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